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FIRST SESSION

THURSDAY, MAY 21, 10:00 A. M.
The Ohio Union—West Ballroom

Presiding:

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L. H. PENNEY, *President, American Institute of CPAs; Partner, L. H. Penney & Company, San Francisco*

Paper: "Controversial Areas within Generally Accepted Accounting Principles"

RALPH E. KENT, *Partner, Arthur Young & Company, New York*

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ANDREW BARR, *Chief Accountant, Securities and Exchange Commission, Washington, D. C.*

WHAT ABOUT CONTINUING EDUCATION?

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During the last half century, the growth of the public accounting profession in the United States has been impressive. It has been more than impressive in the last 10 years; it has been—to borrow an adjective from Hollywood—spectacular. During that decade, the number of CPAs has nearly doubled from about 32,000 to some 63,000. During the same decade, the membership of the American Institute of Certified Public Accountants has risen even more sharply from 13,000 to almost 34,000.

This expansion in number has been accompanied by an increase in the public acceptance of the CPA. But it is only realistic to recognize that the profession's stature is still not fully recognized. The evidence of this lack of awareness of the professional attainments of CPAs is perhaps most clearly revealed in state legislatures which must often be reminded of the need for preserving the integrity of the CPA certificate.

Since the profession is composed of individuals, the profession's stature depends on the stature of those enrolled in it. The public that bestows recognition is also composed of individuals, and its opinion is the composite of a large number of individual views.

Consequently, it is important that every CPA strive to create a favorable impression in all of his contacts. A pleasant personality, proper respect for the accepted social graces, a neat appearance—all of these are desirable qualities. But they are not enough. The CPA must have professional competence. That competence not only insures the value and acceptability of the services rendered to his clients; it also begets an air of self-confidence which, in turn, increases the accountant's prestige in the eyes of the public.

Professional education cannot, of course, end with passing the CPA examination. Accounting is not a dead art; it is alive and changing. If anyone is inclined to challenge that statement, he should examine some of the accounting literature of 1920, 1930, or even 1950. Standards of reporting are constantly being modified. New auditing techniques are being developed. The income tax laws are changing from year to year, bringing new problems in tax accounting practice. Additional opportunities for CPAs are being explored. The demand for management advisory service is constantly growing; governmental accounting and auditing are becoming common fields; new or enlarged outlets for the CPA's skills are being opened up in such areas as the auditing of insurance companies, banks, savings and loan associations, pension and welfare funds. There are others; there will be more.

In order to achieve and maintain his competence, the CPA must engage in a never-ending pursuit of knowledge. He studied to pass the CPA examination and that, together with his early years of experience, brought him to a certain level of competence. Continued reading of technical literature may keep him abreast of some of the advances of his profession. Such haphazard and often inefficient methods of learning, however, can neither adequately prepare him to render satisfactory service in the new and dynamic fields just mentioned, nor keep him informed of all the developments which are occurring with dazzling speed in his rapidly growing profession.

Dr. Earl J. McGrath, former U. S. Commissioner of Education, spoke at length on this subject of continuing education for professional people at the 1957 annual meeting of the Institute in New Orleans. On the basis of his studies of the educational needs of all the professions and their current efforts to meet them, he felt obliged to say that "accounting is far behind the others." The indictment seems fully justified by recent studies conducted by the Institute staff. These studies reveal that a number of organizations serving lawyers, doctors, engineers, insurance men, bankers, credit executives and business managers have established elaborate programs of education for their members. They offer a wide variety of choices to their members for instruction by correspondence, seminars, lectures, etc.—ranging from a day to several weeks in length.

Almost all of these activities are self-supporting. The American Management Association, for example, with 28,000 members, held 1,037 meetings, events, or courses, during the fiscal year ended June, 1958, with a total meeting attendance of 75,000. The American Bar Association, jointly with the American Law Institute, has a comprehensive program which provides material for educational courses given by the various state and local Bar Associations. In 1957 alone, 13,676 lawyers in California took continuing education courses and paid over $200,000 in tuition for them. In one year (1957) more than 1,000 post-graduate courses were presented by the medical profession with more than 35,000 physicians enrolled in formal courses, and 65,000 taking some form of post-graduate education. Incidentally, the American Academy of General Practice has a firm policy of expelling any member who fails to devote at least one hour a week to organized professional study—and has, in fact, dropped over 1,000 members in the last 10 years for neglecting to comply with this requirement.

It is embarrassing to compare these numbers with the 2,289 people who took the three continuing education courses available from the American Institute in the last five years (1954-58). It is true that three or four of the states had education programs of their own so that several hundred, or a few thousand, additional courses were doubtless taken by CPAs, but the numbers are minuscule as compared with those of the American Management Association, the Bar, or the medical profession.

The Institute is now trying to do something about this deplorable situation. An ambitious new and enlarged program of continuing education was authorized by its governing body last year, with an initial appropriation of $50,000. The program was barely launched, however, before it became obvious that it would have to go far beyond vocational training and embrace all aspects of a professional life. Consequently, a more descriptive title, professional development, was adopted to clarify the nature and to indicate the broad scope of the program.

At the Institute's fall meeting in Detroit, a board of managers was elected as the first step in implementing the program. Shortly after its election, the board employed a staff director to head the new division of the Institute: the Division of Professional Development. It also adopted an organization plan for the division and, in doing so, stated the long-range objectives as follows:

"A. The objective of the Division of Professional Development of the American Institute of Certified Public Accountants is to increase the competence and the stature of certified public accountants by making available to CPAs and their staff assistants a well-rounded program of continuing education. Although it is possible that this program may, when completely developed, relieve the universities of some of the vocational training that they have to incorporate in their curricula, it is intended that the courses supplement and complement the university's role. The courses offered and to be offered by the Division of Professional Development are not intended to replace or duplicate any training properly belonging in a college curriculum.

1. A variety of courses will be offered to meet the principal needs of the majority of the members of the Institute.

a. Courses on technical and related subjects will be developed at various levels—from junior accountants to partners.

b. Courses on the administrative aspects of an accounting practice will be offered to all practitioners: individuals, small firms, medium size firms, and large firms.

c. Courses intended to broaden the scope of the CPA's knowledge and to extend it to various fields will be offered.

2. Courses will be adapted to various methods of presentation so as to serve, with most economy and efficiency, both members in metropolitan areas and those in less populated areas. If, for example, 16 hours of "class time" are needed, the materials will permit presentation (a) in two full days, (b) in four half-day sessions, (c) in eight two-hour sessions, or (d) any other combination appropriate to individual situations.

B. It is intended that the division will be operated on a self-sustaining basis.

C. The problem of obtaining instructional staffs of persons who are both technically qualified practitioners and effective leaders may have to be solved by providing practitioners with instruction in effective teaching methods."

While the Board of Managers is expected to exercise general supervision over the Division of Professional Development, it acts, not as a committee, but as a board of directors, controlling the policy and finances but not participating directly in the day-to-day operations of the project. The board will report directly to Council on the activities of the Division.

In technical matters such as the content of courses, their duration, method of instruction, etc., the Director of Professional Development has full authority and is likewise charged with full responsibility.

From an administrative standpoint, the director reports to the executive director of the Institute. For the near future, at any rate, the division will use the facilities of the Institute to obtain bookkeeping, purchasing, duplicating, mailing and other office services.

An advisory committee has been appointed to assist the director at the operating level in selecting suitable subject material for courses, and in determining the best means of effectively presenting courses to the members. The advisory committee is a large committee—73 in all—with members located in strategic geographical areas all over the United States.

The advisory committee members will also be the Institute's official representatives at course offerings. These observers will assist the instructors when necessary in the administrative and technical aspects of the courses and may attend the sessions in an effort to enhance the effectiveness of the courses.

It will not be easy to inspire individual members of the profession to pursue the additional knowledge available to them through these courses. When the American Bar Association's program was only four years old, its Director prepared an article for the Canadian Bar Review (November, 1951) reviewing its operation. He commented on the difficulty of persuading practicing lawyers to enroll in the courses and described how the director, committee members and other officials went into the field "preaching the gospel of continuing legal education and encouraging the sponsoring of state and local educational organizations." He then made this observation:

> "The greatest obstacle was lethargy. Opposition was rare, and then only from an occasional die-hard. Lawyers were almost unanimous in agreeing that continuing legal education is something useful and even essential. They were not so unanimous in their willingness to do something about it. Speeches might bring applause, and did, but they did not always bring action. It was necessary to ferret out leaders in the states and local communities who were willing to assume the initiative and responsibility and to follow through. Such men are not always easily found."

Any program of continuing education must obviously make a forceful appeal to the basic motives which determine human behavior. Some members of the profession may participate in the program because of a compelling desire to acquire additional knowledge for its own sake or to become equipped to render a better service to their clients. But it is only realistic to assume that self-interest will be a more powerful motive—a concern for greater personal recognition and for a larger personal income.

Nor can it be taken for granted that those to be motivated will readily recognize the stimuli. It will often be necessary to identify clearly the practical dollars-and-cents value of continuing education before some members of the profession will appreciate the personal advantages to be derived from it. This may appear to be a debasing task to be performed only by cynics. But the hard fact of life is that few people are prepared to accept readily someone else's assurance about what is good for them; they have to be fully convinced, by argument and by example, that a course of action promises to be personally rewarding. The various state societies of certified public accountants are being asked to join with the Institute as co-sponsors of the courses.

It is hoped that each state society, and perhaps each chapter, will have a committee on professional development, one of whose principal functions will be the merchandising of the professional development program. The Institute will develop and furnish promotional materials which may be supplemented by state societies if they wish. The experience of the bar tells us that promotion of this program is a difficult assignment. We will have to be persistent and imaginative in our efforts to make the members fully aware of the benefits available to them from the program, and to stimulate them to act.

The Institute will maintain sufficient control so as to assure a high quality presentation. If any state society intends to alter a course to the extent that its effectiveness would be seriously impaired, the Institute may withhold co-sponsorship. The same would apply if the alteration was made with respect to the scope, content, method of presentation, length of course, and standards of qualification for instructors.

The state societies will be billed by the Institute on the basis of a fixed amount for each participant in each course, irrespective of the size of the group. The state society in turn would add an amount, giving consideration to its own costs, in order to arrive at a reasonable amount to be charged to each participant. The state society's charges might vary in different locations, but the billing and collecting of fees would be the responsibility of the state society in any event.

If the resources of a state society are not sufficient to permit it to attend effectively to the administrative aspects of the program, the Institute will assume responsibility for whatever needs to be done—though the course will continue to be co-sponsored by the society. It is possible that courses may be given in sparsely settled areas, drawing on members from two or more adjoining states. It is not intended that state lines at any time deter anyone from attending a course at a location convenient to him.

In order to encourage wide participation in the program, travel time and costs to the participants will be kept as low as possible by creating many different training centers. One-day sessions normally should require no more than 50 miles of travel. Travel distances can increase as the length of the session increases. It is entirely possible that some courses might last a full week or two and be given at only a few locations, so that some participants might be required to travel several hundred miles.

The state societies will also be consulted on the selection of training sites, but the Institute recommends that the facilities of educational institutions be used whenever possible. Each participating school will be asked to appoint a person or division to cooperate in making arrangements for courses to be offered at that institution. The school will also be asked to encourage faculty members to serve as instructors for the courses.

It is hoped that eventually a somewhat permanent staff of instructors will be maintained for each training site. In order to achieve uniformity and to increase the effective remuneration of the instructor, a person chosen to give a particular course may be asked to make his presentation in several locations.

Because these activities are intended to be carried on jointly with the state societies, the staff of instructors will be selected by the co-sponsoring societies subject to the approval of the Institute. In the meantime, the Institute is to list and make known the qualifications a person should have to be selected as an instructor for a particular course. All instructors will be paid a reasonable fee for their services.

As noted earlier, the director of professional development started active work last winter. He has now engaged an assistant who will report shortly, and is seeking another. It is also planned to have individual contracts with five or six persons who will be engaged to develop specific sets of course materials.

The training courses to be offered for staff members are intended to last one week or more and to be of practical value to staff members of varying lengths of experience—from the junior to the supervisory or in-charge level. The courses will be primarily instructional in nature. Even though the discussion and seminar techniques may be used, the content of the courses, in essence, will be taught. The subject matter and the program's full scope will be determined only after completion of oral and written surveys of the needs of the members.

Shorter courses dealing with specialized subjects will also be offered in this program of staff training. The areas to be covered will include auditing and accounting problems of different types of business, the management of engagements, tax accounting problems, etc.

Other courses will be designed for sole practitioners, partners, supervisors and non-practicing members. Some of these courses will deal with specialized subjects, many of them similar to those intended for staff men. There will also be courses on the management of an accounting practice and on management services for small business. In conducting these courses, however, the emphasis will be placed on discussion and seminar techniques rather than on teaching. The primary purpose of these courses will be to draw together those who are experts on the subject and those who want to know more about the subject.

The Institute has been offering three courses over the last few years. They are Report Writing, Tax Practice Administration, and Accountants' Legal Responsibility. A fourth one on the Determination and Collection of Accountants' Fees has been prepared and is now available.

The initial courses will be developed for partners and proprietors of accounting firms, although non-practicing members or others who are interested will be admitted. If and when a distinction must be made, the course will be designed for the needs of partners and proprietors of local rather than national firms. The first courses will generally be devoted to the economics of accounting practice and to management services for small business. As noted above, one of the first of the new courses is concerned with accountants' fees. This one-day seminar is based on a pilot seminar held in New York last winter. A three-day program on budgeting—presently being developed at Harvard University for presentation in June—will be adapted for use at other locations.

In the initial stages, the course offerings will be made in single units. After a number of such single unit courses have been successfully offered, related courses will be combined and offered as a coordinated series.

To give you a more specific idea as to the state of development of the program and its scope, the courses that are now available (or that should be available by this fall) include the following:

Report Writing (already available)
Tax Practice Administration (already available)
Accountants' Legal Responsibility (already available)
Accountants' Fees (already available)
Estate Planning
Budgeting for Profit in Small Business (available in August)
The Accountant's Role in Sales Forecasting
The Accountant's Role in Inventory Management and Production Management

The present list of courses which cannot be ready this year, but which may be available as early as some time in 1960, include the following:

Establishing and Maintaining Good Client Relationships
Effective On-the-Job Training Program for Staff Personnel
Cash Forecasting
Financial Administration of Small Business

How to Make Budgets Work
Make or Buy Decisions
Return on Investment Concepts
Staff Training Program for Junior Accountants
Staff Training Program for Senior Accountants

Admittedly, this has been a sketchy outline of the Institute's plans for its program of professional development.

The program represents an adventure—a voyage into uncharted seas where it is reasonable to expect only the unexpected. The plans have been based, of course, on a careful review of the educational efforts of other professions, but it is not even prudent to assume that the procedures which succeeded with other groups will succeed with CPAs—or that procedures which failed for others will also fail for us. The outlined program, therefore, is subject to change in the light of experience.

As we leave consideration of the program, one conclusion seems inescapable. A substantial portion of the practicing certified public accountants must seek the increasing competence attainable only through participation in continuing education, else the CPA's claim to professional status will never be fully recognized. He will be regarded merely as a skillful artisan or technician, lacking in those greater qualities of knowledge, vision, and judgment that mark the members of a true profession.

CONTROVERSIAL AREAS WITHIN GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

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There are many subjects on which a group of accountants can fail to reach agreement. There is one, however, on which we would find our views are in accord. It is that there *are* controversial areas within generally accepted accounting principles.

Much has been written and spoken on this subject. There has been an increasing amount of consideration given to narrowing areas of disagreement by members of the accounting profession. Leading teachers of accounting, thoughtful businessmen in industry and informed representatives of government agencies are also making valuable contributions towards this objective.

As we know, a Special American Institute Committee on Research Program was appointed in December 1957 to consider a new approach to the means whereby accounting research should be undertaken, accounting principles promulgated and adherence to them secured. The basic program recommended by this Special Committee was approved by Institute Council last month and is now being implemented.

The report of the committee sets forth some of the basic considerations it had in mind in making its recomendations. One of these is that the general purpose of the American Institute in the field of financial accounting should be to advance the written expression of what constitutes generally accepted accounting principles for the guidance of its members and of others. The report points out that this means something more than a survey of existing practice: it means continuing effort to determine appropriate practice and to narrow the areas of difference and inconsistency. It goes on to suggest that the Institute can and should take definite steps to lead in the thinking on unsettled and controversial issues.

We will all look forward to the accomplishment of this program. Every effort is being made to get it started on an effective basis. Included in the membership of the first Accounting Principles Board are representatives of accounting faculties and the business world, together with the senior partners of a number of public accounting firms.

As a member of the lame duck American Institute Accounting Procedure Committee, I can unequivocally assure the new Board that our committee will not resolve all of the pending problem areas before it goes out of business this Fall. While we hope, in accordance with President Penney's instructions, to finish certain projects now nearing completion, notably the interesting bulletin on consolidated financial statements, we are quite aware of the enviable position in which we find ourselves of being able to steal silently away and leave our perplexing problems behind us.

What are some of these problems? There are some puzzling ones, such as the question of what to do about the accounting aspects of inflation (which question has been with us in varying degrees of intensity since World War II), income tax allocation, long-term lease obligations, accounting for costs of pension plans, pooling and purchase problems which arise with great frequency in our present period of many mergers and acquisitions, and others. Let us explore a few of these most interesting problems in the time we have available this morning.

Accounting Aspects of Inflation

The first problem area mentioned: inflation, is the one which has received possibly the greatest amount of attention over a period of several years. The degree of interest in the subject parallels the pace of inflation. The removal of price and wage controls at the end of World War II resulted in the first of a series of general increases in costs of material and labor, and thereby reductions in the purchasing value of the dollar. The accounting profession was subjected to heavy pressures from within the profession and outside to permit increased depreciation charges in recognition of the higher replacement cost of plant facilities.

Accounting Research Bulletin No. 33, which was issued in December 1947, dealt with this subject and concluded that accounting and financial reporting for general use would best serve their purposes by adhering to the generally accepted concept of depreciation on cost, at least until the dollar became stabilized at some level.

This bulletin had been in existence only a few months when mounting inflation brought a renewed clamor for review and revision. The Accounting Procedure Committee again considered the matter and in October 1948 published a letter to the Institute membership reaffirming the opinion expressed in Bulletin 33.

This letter acknowledged that there were differences of opinion on the subject but noted that the prevailing sentiment in the opinions expressed in a poll taken of businessmen, bankers, economists, labor leaders and others was against any change in accounting procedures then in effect. The committee felt that such a change would confuse readers of financial statements and nullify many of the gains that had been made toward clearer presentation of corporate finances. It hedged its conclusion somewhat by recognizing that it might at some time become necessary to restate all assets in terms of depreciated currency if inflation proceeded so far that original dollar costs lost their practical significance.

In that same 1948 letter the committee gave its full support to the use of supplementary financial schedules, explanations or footnotes by which corporate management could explain the need for retention of earnings. We know this has only been done in a very few instances, possibly because in the beginning there was a lack of understanding as to how it should be done. The practicing accountant took the view that it was the responsibility of corporate management to assume the initiative, although in retrospect it could be argued the independent accountant should possibly have shared that responsibility.

The committee had another appropriate opportunity to reconsider the 1947 and 1948 conclusion at the time the bulletins were restated in 1953. The Korean episode contributed a further substantial reduction in the value of the dollar and again there was some agitation for change. However, the previous conclusion was reaffirmed, although it is interesting to note that there were six dissents, which was only one less than necessary to block the reaffirmation.

Those dissenting expressed their belief that plant may continue to be carried in the balance sheet at historical cost with deduction for depreciation based thereon. However, they would also permit a supplementary annual charge to income with corresponding credit to an account for property replacements and substitutions to be classified with the stockholders' equity. They suggested the supplementary charge should be in such amount as to make the total charge for depreciation express in current dollars the exhaustion of plant allocable to the period, with the supplementary charge calculated by use of a generally accepted price index applied to the expenditures in the years when the plant was acquired.

The most recent review of this problem was reported on by committee chairman Werntz at the Detroit American Institute annual meeting last fall. Another survey of the opinion of businessmen had been made in 1958, 10 years after the previous one. According to Mr. Werntz, this survey disclosed substantial awareness of the problem but a strong disinclination to adjust reported income unless such adjustment would be an allowable deduction for income tax purposes.

In certain respects the problem is somewhat less acute now than several years ago. There have been significant additions to plant capacity in the 1950's, and consequently a much higher percentage of plant investment is stated at an amount approaching current replacement cost than was true 10 years ago. Liberalized depreciation methods under the 1954 Internal Revenue Code and higher amortization charges on certified facilities have resulted in many instances in substantially greater charges to income in respect of depreciation and amortization.

However, if we are so unfortunate as to have another upward inflationary surge, it seems inevitable that the problem will again become important. I believe it will continue to be a fertile area for constructive thinking by the Accounting Principles Board in collaboration with the enlarged American Institute research function.

Income Tax Allocation

Let us now move into another controversial area, that of income tax allocation.

Accounting Research Bulletin No. 23 was the first major pronouncement on income tax allocation. It was issued in December 1944 and was included as Chapter 10B in the 1953 restatement with a few substantive changes. The issuance of a bulletin on this subject almost 15 years ago is an excellent example of forward thinking. Very little attention had been given to tax allocation prior to 1944, probably because the income tax rates prior to World War II were relatively low—or so they seem with hindsight. With the Federal Government participating on a profit sharing basis to the extent of 52 per cent and with a strong probability of future substantial increases in state taxes, it is self-evident that few items in the income statement provide more impact than income taxes.

The differences in viewpoint on tax allocation have been ably presented in several recent articles in accounting periodicals. Ralph Johns and Weldon Powell have presented the case against income tax allocation in articles in the September 1958 *Journal of Accountancy* and the January 1959 *New York Certified Public Accountant.* Willard Graham supported tax allocation in a talk he gave at the 1958 annual meeting of the American Accounting Association, the text of which appeared in the January 1959 issue of *The Accounting Review.* In a particularly interesting article in the January 1959 *Journal of Accountancy,* Mr. Graham discussed Mr. Johns' arguments against allocation and presented his own reasons for believing that the case in favor of tax allocation is stronger. All of these articles are recommended reading for those of you who wish to keep abreast of current developments in this particular area.

In order to simplify the subject, we should point out that the principal area of controversy relates to inter-period allocation. Through the normal evolutionary process since 1944 we find there has been general acceptance of inter-statement allocation. Specifically, when extraordinary items are of a type and significance sufficient to warrant exclusion from the net income determination in accordance with Chapter 8 of Accounting Research Bulletin No. 43, it is now customary in practice to exclude similarly the income tax charge or credit allocable to the extraordinary items.

There is some reluctance in accounting practice to perform deferred tax accounting in respect of items carried forward in the balance sheet from year to year as assets or liabilities. The degree of reluctance appears to vary depending on whether we are dealing with an actual tax benefit in hand or one which may be obtained in the future. If, for example, development expense is deferred in the balance sheet but taken on a cash basis for tax purposes we have an immediate tax reduction arising from the earlier deduction of the item for tax purposes. It is not uncommon to find this tax reduction credited against the deferred item in the balance sheet or carried on the liability side.

The situation is not as clear when an accrual is made in the accounts for expenses or costs applicable to sales of the period but which will not be deductible for tax purposes until such time as the expenses or costs are paid. Examples of what we have in mind are vacation accruals, provisions for overhaul of aircraft or relining of furnaces, warranty provisions and inventory reserves. There is a strong element of conservatism in most accountants, and we find that while the need for accruing for the expense in order to match costs with revenues is readily understood, there is some objection to taking the next step of anticipating the possible future income tax benefit and giving effect to it in the current period. You will recall that Section 462 of the 1954 Internal Revenue Code would have allowed many accruals of these types to be deductible for tax purposes at the time of accrual, thereby solving our problem quite neatly. Unfortunately, you will also recall the early repeal of Section 462.

There is, as far as I am aware, complete agreement that no tangible recognition should be given in the accounts to possible future tax benefits arising from losses carried forward until such losses are actually used to reduce taxes payable in a later year. Actually, if carefully analyzed, there is not a great deal of difference between the anticipation of future income tax benefit based on our Section 462 examples and that based on carry-forward of losses, except there may be a greater element of doubt in a carry-forward situation as to whether the company will be in a tax paying position, and consequently able to have a tax saving.

It is interesting to note that the need for deferred tax accounting is supported by related but somewhat different viewpoints. This has caused confusion. Let me illustrate by means of a depreciation example, wherein we will assume the usage for tax purposes of the double declining method has resulted in a depreciation provision $10,000 higher than the book provision computed on the straight-line method. With a 52 per cent tax effect, the actual tax payable for the year is thereby reduced by $5,200. Parenthetically, it is at this point that the disbeliever in tax allocation takes the $5,200 into current year net income, stating that the only tax provision necessary is for the tax currently payable. The believers in tax allocation will not permit this amount to be included in current year net income, but they will compensate for it in different ways. One group will make a deferred tax provision of $5,200, either because they are providing for a tax payable in future years or because they believe the current year tax benefit should be deferred. Others will make an additional $5,200 provision for depreciation. The practical result under any of these philosophies is the same: net income for the current year does not retain the $5,200.

There is also no small amount of related confusion as to how this deferred item of $5,200 should be classified in the balance sheet. One school of thought is that the deferred tax is a non-current liability; others, including The Canadian Institute of Chartered Accountants, look upon the item as a deferral of present tax benefit until future years when taxes payable will be correspondingly higher, and therefore they consider it to be a deferred credit.

The believers in tax allocation who increased the current year depreciation provision by $5,200 did so because they believe such a procedure is the most practical means of recognizing the loss of future deductibility of depreciation for income tax purposes.

We have thought of this thus far in terms of a rather simple example —a difference between tax and book depreciation. When we remember that medium and large size companies generally have many more than one reconciling item of material amount between book and tax income, and that certain of these items, such as depletion, do not balance out over a period of years, we become more aware of the complexities of tax allocation. It is a fascinating subject to study in case examples, and I hope the new American Institute research department will give it high priority with the ultimate objective of clarifying the present bulletin on tax allocation. It is also to be hoped that the views of the American Institute, the American Accounting Association and the SEC can be reconciled in order to narrow or eliminate the areas of difference between these groups.

Long-term Lease Obligations

Our next controversial area—long-term lease obligations—is one which has been and continues to be of particular interest to credit grantors. Historically, lease obligations were generally not of sufficient dollar importance to be troublesome from a financial statement analysis viewpoint, although it should be noted that the SEC has required disclosure of material obligations of this type for many years. There have been significant changes in lease obligations, however, in the post-war period of tremendous industrial expansion.

More recently we find a growing trend towards leasing of assets of a type such as trucks, aircraft and aircraft engines, oil tankers, and many others, which heretofore have almost always been owned by the user. These changes require us to re-examine our accounting practices.

In 1949 we were concerned about sale and lease-back transactions. Many companies, interested in finding funds for expansion, discovered that the sale and concurrent lease-back of previously owned plant facilities was a reasonably simple means of obtaining funds. Since many of these properties were carried at relatively low net book values, substantial profits were recorded on the sales. Accountants were particularly concerned with the propriety of recording these profits if the lease agreement contained a repurchase option at an arbitrary price with little or no relation to the property's worth, or in certain instances a requirement that the lessee repurchase the property at the expiration of the lease.

In October 1949, the Accounting Procedure Committee issued a bulletin on disclosure of long-term leases in financial statements of lessees, and this bulletin contains the guiding policy still being followed today. In it the committee expressed its belief that material amounts of fixed rentals and other liabilities maturing in future years under long-term leases are material facts affecting judgments based on the financial statements of a corporation, and that those who rely upon financial statements are entitled to know of the existence of such leases and the extent of the obligations thereunder.

The committee also expressed its opinion that the facts relating to all leases should be carefully considered and that, where it is clearly evident that the transaction involved is in substance a purchase, the "leased" property should be included among the assets of the lessee with suitable accounting for the corresponding liabilities and for the related charges in the income statement.

Since 1949 there have been a number of refinements in lease financing. One of these has been its increasing use for the financing of newly-acquired facilities. In these instances, we have a direct substitution of a long-term lease obligation, frequently for a period substantially equal to the economic life of the facility, for ownership. Ownership causes a diminution of assets or incurrence of liabilities; leasing results in no immediate adverse effect on the balance sheet and merely footnotes disclosure. It is not difficult to understand why the financial officers of a corporation are intrigued by this means of financing.

Another interesting development in lease financing is the usage of dummy corporations. As described in an article to which I will refer a little later on, a dummy corporation is one which is established for the purpose of acquiring certain assets and leasing them to a company. To secure the funds required to purchase the assets, bonds are sold to outside investors. As security for the bonds, the interest of the dummy in the lease is assigned to a trustee, named to represent the outside investors. The company makes its rental payments directly to the trustee and these payments are so scheduled that funds will thereby be made available to meet the interest and principal instalments on the dummy's bonds. The dummy has no operating functions. Its only purpose is to hold legal title to the assets and facilitate the financing.

The common stockholders of the dummy have no responsibility as long as the debt is outstanding since control is vested in the trustee under the terms of the indenture. The common stock of the dummy corporation may or may not have substantial value, depending on the arrangement. If the cost of the asset plus the desired effective interest and financing charge is otherwise provided for, there is no need to allow the common stock to have substantial equity value.

In other instances, it may be the value accruing to the common stock after repayment of the outside debt that contains a significant portion of the financing cost. There are several variations to the type dummy corporation just discussed but the description given will illustrate what is meant by a dummy corporation. In essence, the credit of a company is pledged to make substantial rental payments over a long period of time but no direct liability is incurred which requires inclusion in the balance sheet. Since the dummy corporation is not owned by the lessee, its accounts are not consolidated.

An excellent and comprehensive article on this general subject was written by Donald R. Gant and published in the March-April 1959 issue of *The Harvard Business Review* under the title "Illusion in Lease Financing." If you are interested in this subject, you should not miss reading Mr. Gant's article.

In his conclusion, he puts his finger on the area of controversy when he says "the accountant's devotion to maintaining a thread of consistency from year to year often makes changes in "generally accepted accounting principles" slow in coming about, with the result that these principles are sometimes in conflict with economic logic. . . . The soundness of financial policy which subordinates common sense to accounting convention must be questioned. . . . Accounting standards which were appropriate for the treatment of commercial leasing have proved wholly inadequate to cope with the growing challenge offered by the adaptation of the lease as a financing instrument. Out of these inadequacies has come a curious kind of logic which argues that the existence of an asset can be determined or denied by a ledger entry, and that a promise to pay becomes an obligation only if it is reflected in figures on a balance sheet."

Mr. Gant's viewpoint presents a serious charge against our present day accounting practices. There is rebuttal which can be put forth in support of present practice but our purpose here this morning is to demonstrate that there are controversial areas within generally accepted accounting principles. We cannot hope to locate the problem areas and resolve them all in the same day.

Accounting for Costs of Pension Plans

Let us now move into another controversial area, that of accounting for costs of pension plans. The seed for this controversy was planted as recently as September 1956 when Accounting Research Bulletin No. 47 was published on this subject. It flowered into full bloom during the 1958 recession as corporate officials eyed pension costs with the same cost reduction glare they cast on other expenses.

Possibly, as background, we should first recognize that pension accounting has been a relatively new problem. There are many complicating aspects to a consideration of the problem, such as the handling of vast service costs, informal pension arrangements by which voluntary payments are made to retired employees (usually in amounts fixed at or about the time of an employee's retirement and in the light of his then situation) the policy sometimes followed of integrating other benefits, such as social security, with pension payments, the guesswork involved in estimating future compensation levels where the amount of pension is geared to earnings of the last five or ten years of pre-retirement employment, confusing actuarial valuations and many others. It is not surprising that the Accounting Procedure Committee had considerable difficulty in reaching agreement on a bulletin.

Let us now examine the seeding process. Paragraph 5 of the bulletin states that in the view of many, the accrual of costs under a pension plan should not necessarily be dependent on the funding arrangements provided for in the plan or governed by a strict legal interpretation of the obligations under the plan.

Therefore, notwithstanding provisions for cancellation of the plan, or changes therein, or the existence of a terminal date, this group believes that costs based on current and future service should be systematically accrued during the expected period of active service of the covered employees, generally upon the basis of actuarial calculations. Also, according to this view, costs based on past services should be charged off over some reasonable period, provided the allocation is made on a systematic and rational basis.

Paragraph 6 points out that in the view of others, the full accrual of pension costs may be unnecessary. They say that to do so would require the employer to record pension costs varying widely from his legal liabilities; that a company would, in all probability, never be called upon to utilize the entire amount of an actuarially calculated full accrual; that the accumulation of a substantial accrual would lead to pressure for full funding, possibly to the detriment of the company and its security holders; and also that a policy of full accrual disregards the probability that future unfavorable changes in a company's economic position undoubtedly would lead to changes in the pension arrangements it would make for its employees. This group would permit management to have wider discretion in accounting for pension costs, provided there is adequate disclosure as to the method followed.

Paragraph 7 contains the key wording and I quote it:

> "The committee regards the method outlined in paragraph 5 as being the method most likely to effect a reasonable matching of costs and revenues, and therefore considers it to be preferable. However, the committee believes that opinion as to the accounting for pension costs has not yet crystallized sufficiently to make it possible at this time to assure agreement on any one method, and that differences in accounting for pension costs are likely to continue for a time. Accordingly, for the present the committee believes that, as a minimum, the accounts and financial statements should reflect accruals which equal the present worth, actuarially calculated, of pension commitments to employees to the extent that pension rights have vested in the employees, reduced, in the case of the balance sheet, by any accumulated trusteed funds or annuity contracts purchased."

Now, what happened in 1958? A limited number of companies, whose annual reports received wide distribution, substantially reduced or eliminated their charges to income for pension costs. They stated that no accrual for pension costs was required in 1958 due to higher rates of return then being obtained or expected to be obtained on investments held in pension funds, the appreciation in market value of the investment portfolio, realized or unrealized, and reduced fund requirements due to recession period lay-offs. As further proof of the correctness of their policy, they point out that provisions previously made are adequate to meet the minimum requirement of paragraph 7—sufficient to take care of employees' pension rights which have been vested.

I doubt that the Accounting Procedure Committee members who approved Bulletin 47 had any more intention of approving a failure to provide an accrual for pension costs each year than of approving a policy under which no provision for depreciation is made because hindsight indicates prior years' depreciation provisions were too high.

In an article in the December 1958 issue of *The Journal of Accountancy*, Carman Blough, Director of Research of the American Institute, stated that paragraph 7 was included to avoid requiring drastic changes in many well-established plans which had been set up on some basis other than full accrual, such as pay-as-you-go or terminal funding, and that the accounting referred to in paragraph 7 was not considered as an alternative and equally appropriate method to which a company could shift at any time.

It is fortunate that the wording of the bulletin does not fully and clearly state the committee's intent because there are honest differences of opinion among informed accountants as to how the bulletin should be interpreted. It seems entirely appropriate that action should be taken at an early date, either by the Accounting Procedure Committee or the successor Accounting Principles Board, to remove this area of controversy.

Other Areas of Controversy

There are other areas of controversy but we do not have the time to do more than briefly mention a few of them. The accounting aspects of business combinations, while possibly officially not controversial, are still in a developing status. Considered judgment must be applied to a number of factors in order to determine whether a merger or acquisition should be accounted for as a purchase or a pooling—and the difference between the two alternatives is frequently of crucial importance in a proposed transaction. Your next speaker, in his capacity of chief accountant of the SEC, has almostly surely encountered many more of these purchase vs.

pooling questions than any one of us individually in practice. In his talk at the 1958 annual meeting of the American Accounting Association, which was published in the April 1959 issue of *The Accounting Review*, he summarized some of these questions.

Another problem area, which it is hoped will be resolved or narrowed by the forthcoming bulletin on Consolidated Financial Statements, is the determination of subsidiaries to be included in consolidated statements. The exposure draft of this bulletin states that there is a presumption that consolidated statements are more meaningful than separate statements when one of the companies in the group directly or indirectly has a controlling financial interest in the other companies.

Since a controlling financial interest is described as ownership of over 50 per cent of the voting stock, it seems probable that more companies may be included in consolidation in the future than heretofore when a mere 51 per cent ownership was frequently thought of as insufficient to warrant consolidation. The question as to the accounting to be performed for the rapidly increasing joint 50 per cent ownership situations remains for further study.

A related consolidation question is whether a wholly-owned finance subsidiary operating primarily for the purpose of acquiring, by discount or otherwise, current receivables normally shown in an industrial company's balance sheet, should be included in consolidation with such industrial parent company.

One last troublesome area might be mentioned. This is the accounting treatment of "negative goodwill." While one can find considerable precedent for the handling of a purchase resulting in an excess of cost over the net book value of assets acquired, there is a paucity of authoritative information on the reverse situation which results in an excess credit which must be disposed of. The proposed consolidated financial statements bulletin endeavors, not fully successfully in my opinion, to provide guidance. It also does not cover the question as to whether it is appropriate to apply negative goodwill arising from and acquisition against positive goodwill which originated in another acquisition.

Conclusion

We have touched this morning on a number of controversial areas within generally accepted accounting principles. With the application of research talent to these areas, and the efforts of our accounting principle establishing groups, we can be optimistic as to the resolving of these particular areas of difference. However, we can also be sure that new problems not now being considered, such as possibly the need to reconcile and conform accounting practices on the earth with those on the moon, will present themselves with the passage of time and will require attention. That is what makes the field of accounting an interesting and mentally stimulating one in which to work.

THE INDEPENDENT ACCOUNTANT AND THE SEC

ANDREW BARR
Securities and Exchange Commission
Washington, D.C.

The invitation to participate in this program this morning was most welcome and was accepted promptly, for I knew that predecessors in my office at the SEC had appeared on your programs and had enjoyed the experience.[1] These talks dealt with problems in the application of accepted accounting principles and the presentation of data in financial statements. Furthermore, three years ago J. Sinclair Armstrong, then chairman of the Commission, spoke on "Corporate Accounting Standards Under Federal Securities Laws."

And 21 years ago yesterday, Commissioner George C. Mathews spoke at your first Institute on "Accounting in Relation to Regulation of Security Sales." This paper might well have been in response to today's theme, which I understand is "Social Responsibility of Accounting." Commissioner Mathews spoke of the participation of accountants, engineers and lawyers, the three professional groups which he recognized as most prominent in the scheme of registration and disclosure under the Securities Acts. The doctrine of independence was identified only with the accountants. This doctrine, which evolved with the increase in public ownership of securities, he said was "designed to free the growth and development of accounting of managerial influences and give assurance to the security holders of the accuracy and reliability of the accountant's report." For the development of this concept of independence he recognized the work of the New York Stock Exchange, the growth and strengthening of accounting societies, the creation of departments of accounting in our universities, and the recognition of the value of accounting by the courts and various public agencies. At the same time he cited examples in the Commission's experience (then less than five years) indicating the need for further development of the concept of an independent opinion by the certifying accountant.

Twenty-one years have passed. It now seems appropriate, and con-

[1] The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication by any of its employees. The views expressed herein are those of the author and do not necessarily reflect the views of the Commission or of the author's colleagues on the staff of the Commission.

sistent with the theme of the day, for me to reexamine the concept of independence and to review the development of its application in the work of the SEC.

But, first, what is a public accountant? Norman E. Webster, CPA, explored this subject and reported his findings in two articles in *The New York Certified Public Accountant* for November and December 1944. He found among other things that the American Association of Public Accountants published a booklet in 1888 which defined an accountant and explained what he does. It appears from this that an accountant is "one who is skilled in, or keeps accounts," a person to be respected and not feared; further that "the accountant has integrity and responsibility as his birthright when he enters the guild, and an *independent* audit, under similar organization, would disclose the facts, and to a larger degree cut short the story of defalcation, irregularity, failure and disaster which is but far too frequently told in America, and which points its own moral, severe and lasting as it is, to those who suffer."[2] This discussion preceded the passage of the first CPA law in New York in 1896.

It appears that the newly created New York Board of Examiners for Certified Public Accountants refused certificates to accountants who worked for a single corporation employer, and the definition of a public accountant was still a subject for discussion in journals of the time. One of these, the magazine *Accountics*, in 1899 reprinted an extract from *The Accountant* of London which is pertinent: "The position of an auditor with regard to a company should be absolutely independent, and to a large extent, of course, this is impossible while there is nothing to prevent the auditor being either directly or indirectly interested in the promotion."

In January 1900, shortly after the passage of the Pennsylvania CPA law, *The Public Accountant* of Philadelphia invited leading practicing public accountants to write a definition of a public accountant. The responses from 29 accountants in eight cities are interesting reading. Most replies stressed breadth of experience and nature of the work, but one is remarkably succinct in stating what is expected of an independent public accountant today. Charles C. Reckitt, a brother, and partner for a few years, of Ernest Reckitt, one of the founders of the profession in Illinois, said:

> "A public accountant acknowledges no master but the public, and thus differs from the bookkeeper, whose acts and statements are dictated by his employers. A public accountant's certificate, though addressed

[2] *The New York Certified Public Accountant*, Nov. 1944, p. 671.

to president or directors, is virtually made to the public, who are actually or prospectively stockholders. He should have ability, varied experience and undoubted integrity."[3]

The other replies included those of leaders in the profession whose names are perpetuated in major firms today. An account of the building up of the moral obligations and independence of the public accountant would not be adequate without a reference to Robert H. Montgomery, who had expressed himself with vigor in responding to the request I have mentioned and restated it with equal vigor in the first edition of his *Auditing*[4] where he emphasized his point with a quotation from another leader of the profession.[5] Three years later in his second edition, Montgomery noted the absence of decided cases in the United States on accountants' legal liability and observed that the British cases would serve as guides to the American courts in the event of litigation. In this connection he said : "In my opinion the quickest way to weed out the incompetent men who now hold themselves out as public accountants would be to make them understand the civil responsibility of a professional accountant. Naturally, an unreliable, incompetent man cares nothing about his moral responsibility, and so long as he knows that American courts have never laid down specific rules regulating the duties or obligations of public accountants, he probably feels safe from any legal responsibility. One sure and very desirable result of the weeding out process would be the raising of the professional standard, for a few irresponsible men can offset the good work of ten times their number."[6]

One more reference will complete this short sketch of professional development before the Securities Acts became law. The rules of professional conduct of the American Institute of Accountants, declared effective May 16, 1929, include this important rule:

> (2) The preparation and certification of exhibits, statements, schedules or other forms of accountancy work, containing an essential misstatement of fact or omission therefrom of such a fact as would amount to an essential misstatement or a failure to put prospective investors on notice in respect of an essential or material fact not specifically shown in the balance-sheet itself shall be, *ipso facto*, cause for expulsion or for such other discipline as the council may impose

[3] *The New York Certified Public Accountant*, December 1944, p. 707.
[4] At p. 30 (1913).
[5] A. Lowes Dickinson, C.P.A.
[6] *Auditing Theory and Practice*, 2d ed. Rev. and Enl'd., 1919, p. 4.

upon proper presentation of proof that such misstatement was either wilful or the result of such gross negligence as to be inexcusable.[7]

Note the resemblance here to Sec. 11(a) of the Securities Act of 1933 which says in part: "In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue . . ."

This is enough to demonstrate that the concept of independence was well developed and the value of a review by independent accountants who are in no way connected with the business was established before the passage of the Securities Act—the first of the several Acts now administered by the Commission. These Acts either require or give the Commission power to require that financial statements filed with it be certified by independent accountants, and with minor exceptions the Commission's rules require that such statements be so certified.

The passage of the Securities Act, however, is an important landmark in the development of the concept of the responsibility of the independent accountant to the investor and the public. The original draft of the Securities Act did not require certification by independent accountants. A representative of the accounting profession appeared at the hearings on the bill before the Committee on Banking and Currency of the United States Senate to suggest revisions of the bill.[8] He pointed out that the bill as drafted imposed "highly technical responsibilities upon the Commission as to accounting principles, their proper application and their clear expression in financial statements," and suggested the bill be revised to require that "the accounts pertaining to such balance sheet, statement of income and surplus shall have been examined by an independent accountant and his report shall present his certificate wherein he shall express his opinion as to the correctness of the assets, liabilities, reserves, capital and surplus as of the balance sheet date and also the income statement for the period indicated."

The committee considered at length the value to investors and to the public of an audit by accountants not connected with the company or management and whether the additional expense to industry of an audit by independent accountants was justified by the expected benefits to the public.

[7] Quoted in Montgomery, *Auditing Theory and Practice*, 5th ed., 1934, p. 12.

[8] Statement of Col. A. H. Carter, President of the New York State Society of Certified Public Accountants, before the Committee on Banking and Currency, United States Senate, 73rd Congress, 1st Sess., on S. 875, p. 55.

The committee also considered the advisability and feasibility of requiring the audit to be made by accountants on the staff of the agency administering the Act.

In the report on the bill the Senate committee stated that it was intended that those responsible for the administration and enforcement of the law should have full and adequate authority to procure whatever information might be necessary in carrying out the provisions of the bill, but it was deemed essential to refrain from placing upon any Federal agency the duty of passing judgment upon the soundness of any security.[9] The proposal to require certification by independent public accountants was incorporated in the bill as passed.

With the passage of the Act it became necessary for the Federal Trade Commission to publish rules. This it did in a pamphlet of eight pages which could be obtained from the Superintendent of Documents for five cents. Article 14 of these rules related to accountants and in two paragraphs set the pattern for our present rules. The first of these corresponds to the present Rule 2-01 (a) which states who will be recognized to practice, and the second paragraph dealt with the matter of independence in these words:

> "The Commission will not recognize any such certified accountant or public accountant as independent if such accountant is not in fact independent. Unless the Commission otherwise directs, such accountant will not be considered independent with respect to any person in whom he has any interest, directly or indirectly, or with whom he is connected as an officer, agent, employee, promoter, underwriter, trustee, partner, director, or person performing similar function."[10]

Note that in the first rule and in its republication by the Securities and Exchange Commission[11] in 1935 the independent accountant could not have *any* interest, directly or indirectly, in his client. In a 1936 edition of the rules "any interest" was qualified by the word "substantial."[12] This brought the rule into accord with the October 15, 1934, resolution of the Council of the American Institute of Accountants "that no member or associate shall certify the financial statements of any enterprise financed

[9] Senate Report No. 47, 73rd Congress, 1st Sess., p. 2.

[10] Rules and Regulations under the Securities Act of 1933, Federal Trade Commission, July 6, 1933.

[11] Compilation of Regulations Issued by the Securities and Exchange Commission and Its Predecessor, April 29, 1935.

[12] Rule 650 (b), General Rules and Regulations Under the Securities Act of 1933, January 21, 1936.

in whole or in part by the public distribution of securities if he is himself the actual or beneficial owner of a substantial financial interest in the enterprise or if he is committed to acquire such an interest."[13] The Commission deleted the "substantial" qualification in 1950 but the Institute's rule is essentially unchanged as it applies to public issues of securities. Further comment on the present status of the rules must wait while I explore some of the Commission's experience with accountants.

Lest you get the impression that all of our experience has been discouraging, I want to inject here that it is the violation of the independence rule, or other unprofessional conduct, which gets the publicity. I am sure the profession knows that the Commission appreciates the valuable work that has been done by committees and individual accountants in assisting in the drafting of forms and regulations in the first strenuous years and the constructive comments that have been offered in the same way throughout the life of the Commission. This certainly is acceptance of social responsibility. In our daily work the breaches of the rules are a very small proportion of the total number of cases in which the professional skill of the accountant has resulted in financial statements presented fairly in accordance with generally accepted accounting principles after an audit meeting generally accepted standards. I am sorry that I cannot give you the details of the cases in which the extraordinary diligence and persistence of the independent accountant have resulted in significant disclosures for the protection of investors. This is what the public expects, so it comes as a shock to laymen to find that sometimes accountants are not infallible.

I have reviewed the writing of our rules relating to independence. A few cases in which the concept was developed warrant examination. Recurring questions of surprising frequency demonstrate that we have a new generation of accountants in practice today. Many of these are not familiar with our rules and have not read the history imbedded in our reported cases and summarized or identified in more accessible form in the Accounting Series releases.

The first proceeding[14] involving independence dealt solely with independence and the failure to disclose certain matters with respect to the certifying accountants. The propriety of the financial statements was not questioned and the proceedings were dismissed when an amendment to the registration statement containing the certificate of a new and independent accountant was filed.

[13] American Institute of Accountants, Year Book, 1935, p. 354.

[14] *In the Matter of Cornucopia Gold Mines*, 1 SEC 364 (1936).

The Commission found in this case that a most unusual relationship existed between the registrant and the accountants who signed the certificate as independent public accountants. An employee of the accountants did the accounting and auditing work and at the same time was comptroller of the registrant and in this latter capacity signed the registration statement as the unsalaried principal financial and accounting officer of the registrant. The certifying accountants' compensation was a fixed fee plus a percentage of the gross proceeds of metal sales of the mine for one year. Furthermore, the employee owned shares in the registrant which he had purchased before the filing was made. In their certificate the accountant said, among other things, that their relationship with the registrant was "the usual relationship of independent accountants to their client." The Commission found that this was an untrue statement and that the certification was not made by an independent accountant.

The purpose of certification by an independent accountant is so well stated in this case that it warrants quotation:

> ". . . The insistence of the Act on a certification by an 'independent' accountant signifies the real function which certification should perform. That function is the submission to an independent and impartial mind of the accounting practices and policies of registrants. The history of finance well illustrates the importance and need for submission to such impartial persons of the accounting practices and policies of the management to the end that present and prospective security holders will be protected against unsound accounting practices and procedure and will be afforded, as nearly as accounting conventions will permit, the truth about the financial condition of the enterprise which issues the securities. Accordingly, the certification gives a minimum of protection against untruths and half-truths which otherwise would more easily creep into financial statements. Hence a statement which serves such a high function cannot be dismissed under the Act as a mere 'tag' attached to financial statements. It is a material fact, for it gives meaning and reliability to financial data and makes less likely misleading or untrue financial statements. . . ."

We hear that the real measure of independence is in the accountant's integrity and attitude of mind in dealing with the problems before him.[15] These are certainly fundamental qualities which the Commission was quick

[15] "Essentially it is a state of mind." John L. Carey, *Professional Ethics of Public Accounting*, American Institute of Accountants, 1946, p. 7. The short quotation was qualified by citing the need for objective standards. Ten years later Mr. Carey said that "It is most important that the CPA not only shall refuse to subordinate his judgment to that of others but that he be independent of any self-interest which might warp his judgment even subconsciously in reporting whether or not the financial position and net income are fairly presented. Independence in this context means objectivity or lack of bias in forming delicate judgments." (*Professional Ethics of Certified Public Accountants*, American Institute of Accountants, 1956)

to recognize. In an early case[16] it was said that where an accountant has consciously falsified the facts an inference of actual absence of independence would seem to be justified. An accountant must approach his "task with complete objectivity—critical of the practices and procedures of registrants, and unwilling to aid and abet in making statements which the facts do not warrant."

From time to time it has been urged upon us that an accounting firm should be permitted to certify financial statements when one or more of the partners could not be considered independent because of a financial interest in the client or other complication under the rules. In these cases it is represented that other partners will supervise the audit and the disqualified partners will not participate in any way. This argument was used in an early mine promotion in which one of the partners accepted his fee in stock of the registrant and the staff applied the rule. An amended balance sheet was filed which was certified jointly by an individual and the original firm. The individual was said to be an employee or associate of the senior partner or the firm but was paid directly in cash by the registrant. The Commission found that the independence rule would be defeated and evaded if the senior partner was disqualified but his partner or employee was not and concluded that the amended balance sheet was not certified by an independent accountant as required.[17] In a recent case, it became necessary to apply the ruling in this case and a similar ruling of the American Institute of Certified Public Accountants Committee of Professional Ethics.[18]

In an unusual case 20 years ago it was found that, unknown to the certifying accountants, their superviser in charge of the audit had kept certain books of a client. This situation came to light when it was discovered that the client's financial statements for several years were false and that the accountants' employee was responsible for the false entries. The Commission in its opinion agreed with the partner of the accounting firm

[16] *In the Matter of American Terminals and Transit Company*, 1 SEC 701, 707 (1936). See also *In the Matter of Metropolitan Personal Loan Company*, 2 SEC 803, 813 (1937) in which the Commission found that the accountants were not independent and commented that "The requirement that the certifying accountant be 'independent' is not mere verbiage. The testimony reveals that * * * and * * * completely subordinated their judgment as accountants to the desires of their client in setting up items questioned in the balance sheet and profit-and-loss statements. * * * testified that he wasn't sure of an accountant's function in this respect and that he generally did what his clients requested."

[17] *In the Matter of Richard Ramore Gold Mines, Ltd.*, 2 SEC 377, 389 (1937).

[18] *C.P.A. Handbook*, Chapter 5, Appendix A, Rule 13, p. 7.

who testified that "an audit should be a check by an outsider of original work done by the client's employees; 'if an accountant is permitted to do original work, the whole purpose of the audit is lost'."[19]

These few cases from the first five years of the Commission's experience have been the guides in deciding cases in the last 20 years. There have been variations in circumstances, but we have in these cases examples of conflicts of interest due to financial interest, direct employment by the client, and apparent submission to the will of the client without other complicating factors. These matters are covered in our rules[20] and in part in the codes of professional ethics of the Institute and of the state societies of certified public accountants. The frequency with which my office must answer questions on matters of this kind suggests the possibility that greater emphasis could be put on the subject of professional ethics in the colleges and by the accounting societies.[21]

I am, of course, aware that much effort is directed along these lines, but it cannot be relaxed. The codes of ethics, in my opinion, could be reexamined in one major area at least. Most of the codes have a double standard on the subject of financial interest—permitting no substantial interest in a client with a public distribution of securities, but only requiring disclosure of such an interest to private lenders. Many cases coming to our attention are those of accountants who have served closely-held corporations and are entering the public financing area for the first time. I was encouraged by Thomas G. Higgins' remarks at Detroit last October when he discussed this dual standard and said that "It is really difficult to see why the rule should be different for statements used for public financing and those used as a basis of credit."[22]

He also remarked that "There is a growing feeling that the Institute's rule on investment in clients should be more comprehensive than it is and that it probably should parallel the Illinois rule, which is essentially the rule of the SEC." Most accountants seem to recognize that they should not be an officer or director of the client whose statements they certify, but perhaps the codes could be strengthened by covering this point too. Such strengthening might relieve accountants from pressures by well-meaning clients.

I have not dealt with the general problem of the improvement in auditing procedures and the definition of generally accepted auditing

[19] *In the Matter of Interstate Hosiery Mills, Inc.*, 4 SEC 706, 717 (1939).

[20] Rule 2-01, Regulation S-X.

[21] See Accounting Series Release No. 81, December 11, 1958, for a Compilation of Representative Administrative Rulings and references to published cases on independence.

[22] Thomas G. Higgins, "Professional Ethics and Public Opinion," *Journal of Accountancy*, November 1958.

standards which have received a great deal of attention in the profession and by the SEC particularly since the McKesson & Robbins investigation. This case may be cited as an example of the profession coming forward both individually and in national and state organizations to examine a serious problem among themselves, by assisting the SEC as expert witnesses, and thereafter in promoting the use of the extended auditing procedures which were found necessary as a result of the investigation. The fraud had been exposed on or about December 5, 1938. On January 6, 1939, committees of the American Institute of Accountants and the New York Society of Certified Public Accountants made a joint statement at a meeting with the attorney general of the state of New York in which they said: "Professional accountants, in sponsoring CPA legislation, adopting codes of ethics, and establishing standards of procedure, have assumed heavy responsibilities, and by statute and court decision additional responsibilities have been imposed upon them. All reputable accountants assume a responsibility to persons other than those who employ them. The greatest asset of a public accountant being his reputation for competence, care and integrity, it is essential that he guard that reputation with all diligence. The legal penalties imposed on accountants for fraud, deceit, or gross negligence are so severe that no practitioner would deliberately risk incurring them."

Strengthening the understanding of the meaning of independence by all members of the profession is a vital factor here. In this connection I want to highlight one finding in the McKesson report that an audit which relies heavily on a proper appraisal of the client's system of internal check and control "should not . . . exclude the highest officers of the corporation from its appraisal of the manner in which the business under review is conducted."[23]

By this brief review of the concept of independence, I believe I have demonstrated that the Securities Acts embraced what had become good business practice. Any course of conduct by the profession which may have the effect of undermining public confidence in the independence of the accountant who certifies financial statements upon which third parties are asked to rely would destroy the usefulness of the accountant's work in the securities field. It is for this reason that the SEC has vigilantly guarded the concept of independence—so firmly in some cases as to bring criticism from the properly constituted guardians of the profession's code of ethics. These reactions have been disturbing but at the same time I know that our intent has been to promote the highest standards in one of the most important qualities of the accountant in public practice.

[23] Accounting Series Release No. 19, p. 35 (1956 ed.).

SECOND SESSION

THURSDAY, MAY 21, 12:30 P. M.
The Ohio Union—East Ballroom

Presiding:

GORDON S. BATTELLE, *President, The Ohio Society of CPAs; Partner, Battelle & Battelle, Dayton*

Presentation of The Ohio Society of Certified Public Accountants awards to the highest candidates in the Fall 1958 CPA examination, made by EDWIN F. CATHCART, JR., *Chairman, Committee on Accounting Education, Ohio Society of CPAs; Ernst & Ernst, Cleveland*

SECOND SESSION

The awards were made to Frederic H. Fiske for highest proficiency, and to William T. Van Fossan for second highest proficiency.

Mr. Fiske graduated Phi Beta Kappa, Albion College, Michigan, and is presently a staff accountant with Price, Waterhouse & Co., Toledo. Mr. Van Fossan graduated from Miami University, Oxford, Ohio, and is now affiliated with the firm of Peat, Marwick, Mitchell & Co., Cleveland.

THIRD SESSION

THURSDAY, MAY 21, 2:00 P. M.

The Ohio Union—West Ballroom

Presiding:

MARTIN L. BLACK, JR., *President, American Accounting Association; Professor of Accounting, Duke University, Durham, North Carolina*

Paper: "The Great Depreciation Illusion" (The Need for Depreciation Reform)

H. T. MCANLY, *Partner, Ernst & Ernst, Cleveland*

Paper: "The Development of Modern Internal Auditing"

WILLIAM J. LEHMAN, *President, Institute of Internal Auditors; General Auditor, Lockheed Aircraft Corporation, Burbank, California*

Paper: "Reporting Financial Data to Management, Stockholders and Employees"

ARTHUR H. SMITH, *Director of Management Analysis, General Mills, Minneapolis*

THE GREAT DEPRECIATION ILLUSION

(The Need for Depreciation Reform)

H. T. McAnly
Partner, Ernst & Ernst
Cleveland

There are some professions where the main gauge of a man's ability is his skill at creating an illusion. The theater is such a profession, as you know if you have ever seen Charles Laughton, on a bare stage, bring tears to the audience's eyes with the sound of his voice. Illusion is also an important part of advertising.

But in accounting, just the reverse is true. One of our main functions is recognizing illusions, and replacing them with facts. Yet the unhappy message I would like to set before you today is that the accounting profession has been helping *keep alive* an illusion, one that is sapping the strength of American industry at the rate of more than one half a billion dollars a year.

The illusion can be briefly stated: American industry is led to believe it adequately is depreciating its capital assets.

The fact is that present-day methods of accounting for depreciation make no allowance for the effects of inflation, and inflation is eroding the value of every depreciation dollar at a virtually predictable rate of about 3 per cent a year.

Increasingly, the concept of regular, gradual inflation seems to be winning acceptance in our national philosophy. We have been living with inflation for a long time, and perhaps we are getting used to it. Some economists (let us hope not too many) believe it to be a desirable trend that should be encouraged.

A dramatic and somewhat painful illustration of what inflation has done to us was pointed out recently by T. Coleman Andrews. In his book, *Wasteful Spending*, he tabulates the effect of increased taxes and inflation on individual incomes. An income of $5,000 a year, he says, in 1939, was equivalent in purchasing power to a 1957 income of $13,000. A 1939 salary of $12,500 would buy as much as a 1957 salary of $41,800.

The continuation of inflationary trends is almost assured by the growth in the size of the federal government, and by the necessity of massive expenditures for defense. As a nation, we have seemed to be unwilling to pay for such tremendous expenses on a current basis; so we attenuate the currency a little each year, shifting part of the burden off to a later time. If there were any hope that inflation could be headed off *in spite* of the size and nature of government programs, it would seem to be lost when we realize that too many people in this country really do not care very much. A little inflation does not hurt anybody, they say; there are more important things to worry about.

It is not my aim today to decry inflation; but it is important, it seems to me, for us accountants to recognize the unfortunate fact that we *have* inflation, and that we are probably going to have it, as a more or less regular thing, for as far into the future as anyone can see.

Along with this premise comes a long-recognized axiom: during a time of inflation, depreciation as we think of it is automatically inadequate. Dollars are symbols, and what we intend to set aside through depreciation is purchasing power—not engraved slips of paper. By the time an asset is said to be fully depreciated, we have set aside enough slips of paper, but we have not set aside enough purchasing power.

Yet the illusion that industry is properly depreciating its assets continues to be widely accepted, and little has been done to replace the illusion with facts. Why not? I think there are two principal reasons.

The first is conservatism. While agreeing that current depreciation methods are inadequate, many persons in our profession believe that no really workable improvement has been suggested. If this is the case, the argument would be a good one, but I propose to show, in a few minutes, that a workable improvement in methods has, in fact, been developed during the past decade.

The other basic reason for reluctance to adopt reformed depreciation methods may be a human one rather than a logical one. Many companies do not want to be told that they ought to put an additional charge against earnings, especially if not recognized for taxes. Stockholders, particularly in widely-held corporations, have their eyes fixed on earnings per share, and these earnings are already being squeezed by competition and by consumer pressure on prices. Whether the accountant is ready to look a client in the eye and tell him there ought to be larger depreciation charges, or whether he prefers to let the old illusion continue, depends on the accountant's relationship with his client. This, in turn, resolves itself into a question of whether the client looks on his accountant as a necessary evil, from whom he will accept as little instruction as possible, or whether he sees his accountant as a professional, trained at finding facts and presenting them clearly, so that management can deal realistically with business problems.

It is *not* possible to deal realistically with business problems if profits are overstated. Exaggerated earnings, as everyone knowns, encourages many kinds of extravagance. They encourage excessive dividend distribution. They encourage a willingness to shave profit margins a little closer, in the heat of competition. They encourage a freer hand in both capital and expense spending. They encourage yielding attitudes in labor negotiations.

Let us go back for a moment to the matter of conservatism as a reason for continuing traditional methods of depreciation. There are two ideas implied by the word "conservatism." One is the notion of clinging to the past—and shying away from anything that seems to be new, whether it is good or bad. The other is the notion of *conserving:* of caring well for the good things we have, and not tossing them lightly aside or allowing them to be dissipated. It is this second sense of the word that has the most meaning in our profession, and it is also this sense of the word that should alarm us when we see inflation dissipating our clients' capital investment.

Before describing what I believe is a workable improvement in depreciation methods, let us set down a comment on the basic purpose of depreciation, as a goal to keep in mind. There is an important reason for doing this, because the subject of depreciation methods is one of the world's happiest hunting grounds for people who like to argue, and it is a subject easily clouded with irrelevant ideas.

You can confuse the issue, for example, by arguing that technology is advancing so steadily that scarcely anyone ever replaces a wornout capital asset with an identical new asset, and that the effect of technological improvement makes it impossible to establish a meaningful relationship between depreciation and replacement. Or you can really confuse the issue by arguing that depreciation funds are constantly being reinvested in a business, and so are earning profits long before they are required for replacement of the original asset, and thus may create more profits than are lost through inflation. This is set forth in an article in the March 1959 issue of *The Journal of Accountancy*, entitled "What Happens to Depreciation." Unfortunately, in this article the author does not suggest that these added profits be set aside as needed to cover the inadequacy of the cost depreciation provisions. Whatever they may amount to, they become a part of the total profit considered available for distribution in taxes, dividends, price reductions, wage increases, etc. Thus this total profit must be reduced by the inadequacy of the depreciation provisions to reflect a realistic statement of available profit of a going business.

Another choice justification for dodging this issue is the argument that is advanced by our taxing authorities, that certain types of individual investment may also suffer from inflation and no relief is offered taxwise. These arguments fail to take into consideration that investments of this type are not a necessary continuing investment. They are a matter of choice by the individual, whereas the plant investment of a business enterprise is a required continuing investment which cannot be shifted. Perhaps recognition will eventually be given in pension programs, to adjustments reflecting changes in cost of living index, but until such remedial devices are provided, we should not use it as a justification for neglecting the preservation of the tools of the industry.

If you allow these smoke screens to drift away, the principal purpose for keeping track of depreciation costs is clear. Albert Gaylord Hart probably said it as simply as anyone could: "A main object of keeping track of these costs is to measure income correctly—so that if the whole supposed income of a business is withdrawn for the private use of the owners, it will not later be discovered that the assets of the business have dwindled away."

The fact is that present generally recognized depreciation methods are not fulfilling this main objective. Income is *not* being measured correctly, and assets *are* dwindling away.

This is not an academic matter, but one that should worry everyone who is interested in the future of business in this country. As one example of its implications, consider our competition with foreign countries. You are probably familiar with the development of European industry as it affects us but let me refresh your memory with one interesting set of statistics. In 1947, U.S. exports to Europe totalled $5.8 billion; in 1957, the dollar total was approximately the same. Then the 1957 dollars are devaluated to a 1947 basis, the quality of exports to Europe are about one-half of those in 1947. On the other hand, imports from Europe have increased from $870 million in 1947 to $3.1 billion in 1957, and when adjusted for price inflation still represent more than double 1947.

There is no need for me to add to what has become a steady flow of comment on the rise of technology and manufacturing skill in foreign countries. My purpose instead is to throw a strong sidelight on the problem of inadequate depreciation. Adequate funds must be provided for continuous reinvestment in improved technological processes in the United States of America if we are to compete with other countries.

It is self-evident that as inflation continues, most businesses cannot maintain their physical plant and equipment at even a constant level without the regular introduction of new capital unless they can provide adequate depreciation provisions. The tax law should encourage manufacturers to replace capital assets as they wear out—encourage, that is, in the sense that they would no longer be discouraged from doing so, as they are under present law which allows only recognition of historical cost write-offs.

There is a reasonable and workable solution to the problem. For more than 10 years, a few of us have been advocating the need for recognition of the change in purchasing power of funds recovered in depreciation through the introduction of a reserve to prevent capital impairment. In 1950, I had the privilege of presenting this subject to your Twelfth Annual Institute on Accounting. The presentation at that time covered the means of setting up adequate accruals of the accumulated depreciation deficiency. If recognized, accountwise, tax recognition in some form should eventually follow. However, industry has been reluctant to proceed without some assurance of tax recognition. Congress and the Treasury Department have advanced a primary argument that it would be difficult to justify, as a current tax deduction, the accrued deficiency since the actual moneys have not as yet been expended and conditions could change so that their need failed to materialize.

Recently an answer to this objection has been developed, called "Reinvestment Depreciation." It was submitted to Congress in July, 1958, and re-submitted in 1959. (Present Keogh Bill HR 131.)

Briefly, "reinvestment depreciation" is a method of calculating the effect of inflation at the end of the useful life of assets and qualifying the resulting dollar figure as a tax deduction. The deduction would apply to the extent that new assets were purchased within a reasonable period of time. The calculation would employ an appropriate government index of capital purchasing power computed each year.

As a tax measure alone, it does not provide the funds to cover the full accumulated accrual of the depreciation deficiency caused by inflation. It would provide (at present tax rates) for 52 per cent of the funds needed to cover the decline in the value of the dollar between the time of the original investment and the time the replacement expenditures are made. Thus it is only a timing device for the tax deduction; it must be coupled with sound accounting methods for recognizing the year-to-year accrual of depreciation deficiencies so as to reserve funds sufficient to meet the after-tax portion of the deficiencies.

The tax proposal has been well thought out and is strongly supported.* Whether it will become law remains to be seen. In considering its possibilities, we would do well to remember that normally and naturally legis-

*(Among the groups which testified in favor of the proposal, at hearings held before the House Ways & Means Committee, were the American Cotton Mfrs. Institute, National Lithographers Assn., Inc., the Association of American Railroads, and the National Coal Association. Other groups which have gone on record, either as associations or individual taxpayers, favoring reinvestment depreciation are the cement industry, the American Pulp & Paper Association, the Copper and Brass industry and the American Iron & Steel Institute.)

lative tax provisions follow rather than precede business practice. The inadequacy in present depreciation should be recognized and corrected in business practice as well as in the laws that govern the taxation of businesses. It would require artful persuasion to win general acceptance for a tax reform on the basis of reasoning that business preferred to ignore in its own accounting.

The establishment of methods for reflecting changes in dollar purchasing power is by no means an unprecedented step. There is a significant parallel between the reinvestment depreciation concept, coupled with adequate accruals, and the well-established solution for eliminating from income the effect of fluctuating costs of inventory investment through the use of LIFO. The deficiency in historical cost depreciation provisions results because we have failed to develop techniques compared to LIFO, through which we could charge against income, as depreciation, amounts representing recovery of original purchasing power. Under LIFO, because of relatively fast turnover as compared with plant assets, the added capital needed to carry the inventory investment is actually expended during the current year and becomes a deduction from income, both accounting-wise and tax-wise. However, plant investment expires or turns over only a fraction of a turn annually and the expenditures for replacement that continue a corporation as a going concern will be made in future years. Proper accounting should provide for accruing the accumulated depreciation deficiency and thus covering the added capital that will be needed to maintain the plant asset investment when replacements take place.

Reinvestment depreciation as a tax measure would recover the taxes applicable to the accrued depreciation deficiency at the time the money is needed to effect plant asset replacement. It would seem that if business accounting practice calls for the accrual of the cost depreciation deficiency (even though on a basis that can only be approximate), Congress would be more inclined to provide, through the reinvestment depreciation measure, for its ultimate recognition when the actual amounts become determinable through asset retirement and the re-expenditure of funds. It would also seem that failure to provide for the net after tax amount of the deficiency—on the company books, as an annual accrual and a reduction of net profits—could be construed as asking for only 52 per cent of the amount needed while ignoring the 48 per cent balance as a reduction of past available profits.

Let us briefly review the accounting procedure which will accrue the net after tax depreciation deficiency annually, providing ultimately for the tax recoupment portion through the proposed reinvestment depreciation measure. The essential point is that we recognize currently the change in the purchasing power of all funds being recovered in depreciation. This adjudgment in the accrued depreciation provisions can be represented by a "reserve to prevent capital impairment." The adjustment, to be realistic, must allow for the change in the value of the dollar from the date the assets were originally purchased to the end of the fiscal year being reported. To conform to change in the value of the dollar, adjustment of the accrued depreciation should cover not only the current year but also all prior years. Under the reinvestment depreciation measure, the cumulative adjustment would become a tax deduction in total when the asset is retired if funds comparable in amount were expended within a reasonable period.

A prerequisite of such a method, a reliable index of the current value of the dollar, could easily be based on facts already gathered and issued by the government. Already available are the Department of Labor's cost of living index, the Bureau of Labor Statistics wholesale commodity index and the several construction cost indices. The index selected would not be of fundamental importance so long as all companies and taxpayers used the same one. We are not talking about replacement of specific assets, but the adjustment of depreciation dollars to their approximate current purchasing power.

The depreciation provisions for the year could be computed on any of the generally accepted bases: the straight-line, diminishing balance, or production method or any combination of these. The accumulated reserve for depreciation on cost at the end of the year should be broken down into the amounts which apply to the assets by the years of acquisition. The accrued depreciation applicable to the assets acquired each year should be adjusted for the difference between the index of that year and the current index. The total of the adjustments would represent the total depreciation deficiency. The difference between the amounts so determined at the beginning of the year and the end of the year would represent the adjustment of the accumulated depreciation deficiency applicable to the current year.

Thus the additional depreciation deficiency computed as applicable to the current year covers both the amounts applicable to the current year's provisions and the adjustment of the prior years' provisions.

Assets should be depreciated until the reserves for depreciation on cost equals the original cost (or until retired) regardless of the additional amounts which have been provided for the depreciation deficiency and credited to the reserve to prevent impairment of capital.

The tax eventually recoverable on these provisions for the accrued depreciation deficiency could be reflected as a long-term receivable but probably more properly deducted from the reserve to prevent capital impairment through accruing the latter on a net-after-tax basis since its realization results from eventual recognition tax-wise of the reserve provision.

The present tax proposal calls for entering the new so-called replacement additions at the written down value, thus in substance giving back the tax recovery through future reduced depreciation, but again computing the future deficiency in depreciation by comparisons with the written down value. This section of the tax proposal should be revised.

The tax recovery through reinvestment depreciation covers an accrual at the end of the asset's productive life and is thus retroactive, the value of the new assets acquired at that time should not be affected. Thus all additions should always enter the property records at the dollar level as of the date of their acquisition. Subsequent depreciation would be figured on the cost, with adjustments for additional depreciation based upon the relationship of the current dollar index to the value of the dollar at the date of acquisition.

With reinvestment depreciation as a tax measure, taxes would be recovered as assets are retired and monies expended equalling their costs adjusted to a current dollar basis. However, this tax recovery should not affect the current profit picture since the accumulated accrual of the deduction on a net-after-tax basis has been charged against profit and thus recoverable taxes have been provided for.

With the reserve to prevent capital impairment covering the accrual set up net after taxes, the tax recovery through reinvestment depreciation becomes in effect a credit to the reserve to prevent capital impairment. If the reserve has been carried on a gross accrual basis and the recoverable taxes carried as a long-term receivable, then the tax recovery through reinvestment depreciation merely represents the payment of a receivable. Thus, under either basis, the reserve to prevent capital impairment will eventually contain the total amount needed to cover the decline in purchasing power of the funds recovered in depreciation provisions—both the amount recovered in taxes and the amount properly provided for out of net profit. However, because of the lag in actual realization tax-wise, it would seem that the gross amount of the depreciation deficiency (the net after tax accrual plus the tax recovery) should be transferred to appropriate capital and reserve for applicable future taxes accounts as permanent resting places at the time the total funds covering the deficiency are expended and the actual current tax recovery takes place.

Also retirements that take place which exceed the current additions within the period provided in the tax measure, will call for additional adjustments to the reserve to prevent capital impairment to cover the loss of the anticipated tax recovery with subsequent transfer to the permanent capital account.

Thus, the net after tax reserve to prevent capital impairment would at the end of any accounting period cover the cumulative accrual applicable to plant asset in use; and the more or less permanent capital and reserve for future taxes accounts set up to contain the transfers from the reserve to prevent capital impairment would cover the gross amount of the depreciation deficiency applicable to assets which have been retired.

The reserve for future applicable taxes should cover the taxes (probably on a capital gain basis) which would be payable in the event of retrenchment or liquidation. The reinvestment depreciation concept emphasizes tax relief on a going-concern basis by providing for tax deductions only on depreciation recoveries which are reinvested. Unfortunately, in its present form it also provides for giving back the tax relief in the immediate subsequent periods through reduced depreciation tax write-offs. Under an accrual method encompassing reinvestment depreciation as to the time of tax relief, the future tax liability applicable to the amounts which have been allowed as tax deductions covering deficiencies in depreciation provisions should not be payable as long as the going-concern needs exist.

Under the reinvestment depreciation provision such as is contemplated, retirement of assets should, as a practical matter, be broadly defined to include all fully depreciated assets, in other words, book retirement as well as physical retirement.

Actually in theory, fully depreciated assets which are still in use continue to be affected by inflation so they should continue to remain in the plant assets and depreciation reserve accounts and be included in the calculation of the total accrued depreciation deficiency. However, the difficulty of determining specific asset retirements for the calculation of the tax deduction in many situations would make this impractical. While treating fully depreciated assets as retired would prevent further accrual of any depreciation deficiency if they remain in use, it could result in the use of more realistic depreciation rates, rather than the present tendency to get all the traffic will bear.

As sound accounting procedure, the use of a reserve to prevent capital impairment covering the depreciation deficiency arising from the decline in the purchasing power of the dollar, even though it is not currently deductible for tax purposes, has many parallels, for example:

Reserves to cover product guarantees or warranties

Reserves to cover nonqualified pension programs

Reserves to cover deferred maintenance such as furnace relining, kiln rebuilding, etc.

Reserves for bad debts (under the charge-off method for taxes)

In all these, the tax deduction takes place when the event has occurred. Accounting-wise, however, the accrual has been set up for each accounting period on as accurate a basis as can be estimated. In theory, these reserves should be set up on an after-tax basis, although they are often set up on a gross basis because of their relatively small effect on total profit or loss.

Likewise, reinvestment depreciation provides for the tax deduction at the end of the life of an asset when the funds which should have been recovered in depreciation are reinvested in plant assets. However, unless the full amount of the accumulated depreciation deficiency (as well as the original cost) has been accrued against past profits, they may have disappeared in dividend distributions, higher wages (based upon profit, either directly through profit sharing or indirectly through demands based upon overstated available profits) or in price reductions based on inadequate depreciation charges in costs.

In review then, as sound accounting procedure, at the end of each accounting period, the cumulative accrual of the depreciation deficiency (reserve to prevent capital impairment) would be calculated and the necessary adjustment of the beginning of the year accrual would represent an adjustment of income for the year. With reinvestment depreciation as a tax deduction, this accrual would be on an after-tax basis.

When reinvestment depreciation results in tax recovery, the amount of recovery plus the applicable net after tax accrual contained in the reserve to prevent capital impairment would be transferred to appropriate capital and future tax reserve accounts.

Retirements which result in no tax recovery, because of limitation of the tax measure as to replacement period, etc., also call for adjustments to the reserve capital impairment to a gross (before taxes) basis, with subsequent transfer to the appropriate capital account.

The adjustments of the cumulative depreciation deficiency accrual could be either up or down, depending upon the change in the current index. The adjustment contains a cumulative correction of the prior years' accruals. If tax rates change, the adjustment would also be affected since the accrual would be on a net-after-tax basis. However, it could be properly described on the income statement and if the portion affecting prior years is substantial, it could be shown separately and so labelled.

We may as well recognize that there appears to be little chance that Congress will provide business with a tax deduction of depreciation deficiency as it accrues. It is contended that the index may change substantially before the funds are needed for the actual replacements, or that the funds may never be needed if retrenchment takes place. However, failure to permit the accrual as a current tax deduction does not eliminate it as a reflection of fact, nor excuse the accountant from providing for it, just as he provides other accruals for possible losses which also become tax deductions only when and if they materialize.

Thus reinvestment depreciation, which answers the main objections advanced to previous tax proposals for the accrual of depreciation deficiency, can be coupled with the accrual method and the combination conform to both sound accounting practice and reasonable tax procedure.

Reinvestment depreciation as a proposed tax measure will serve as a stimulant to business and should not result in any decrease in current national taxable income. It couples a tax recovery with an expenditure of several times the amount of the recovery. The expenditure itself represents business on which taxes will be paid: corporate taxes, individual taxes on the labor created, and taxes on dividends distributed out of the added profit. For example, a $52 reinvestment depreciation tax recovery represents $100 to deficiency recovered, and at an index of 200 would call for $200 in expenditures for additions, all of which represents sales volume and increased business activity. This $200 should, as a minimum, create corporate taxable income of primary and secondary, etc., suppliers of $40.00 resulting in $21.00 tax. Individual income taxes collected on the labor created through all the steps of production set in motion (including the production of items which will be purchased by the employees and shareholders receiving added income) plus the taxes collected on dividends distributed out of the added profit (even if computed at the lowest personal income tax rate of 20 per cent) would certainly exceed the balance of $31.00 necessary to offset the $52.00 tax recovery permitted to the company. To the extent that additional business is thus created, the measure would take nothing currently from the Treasury Department and actually could increase total current taxable revenues.

In summary, these facts seem to stand out:

- - - - - The recognition of the change in the purchasing power of dollars recovered in depreciation provisions is a necessary and realistic approach in reflecting available profits of a going concern.

- - - - - Reinvestment depreciation as a tax measure is a sound and practical means of timing the provisions for the accrued depreciation deficiency as a tax deduction.

- - - - - Proper recognition of full depreciation provisions, tax-wise and accounting-wise, not only will serve to conserve the tools of production, which is our nation's chief source of abundance and wealth, but can actually stimulate business through encouraged expenditures and, most important, help to keep us out in front in technology and manufacturing skills.

CONCLUSION

In closing my remarks, let me make four specific suggestions:

(1) That we as accountants cease to keep alive the illusion that present depreciation practices are adequate.

(2) That we stop confusing the issue with statements to the effect that technological advances make it impossible to relate depreciation and replacement, for no specific relationship is necessary.

(3) That we have no part in supporting the insinuations that just because funds recovered in depreciation can be used profitably until needed for replacement, there is no need for recognizing the full depreciation deficiency which should be charged against profit.

(4) That we take an affirmative and realistic approach in correcting the depreciation illusion. There is only one way of doing this and that is by replacing present accounting procedures with accounting practices which will reflect the facts.

THE DEVELOPMENT OF MODERN INTERNAL AUDITING

WILLIAM J. LEHMAN
General Auditor, Lockheed Aircraft Corp.
Burbank, Calif.

During the last 10 or 15 years, the profession of internal auditing has grown at a very rapid rate. Business organizations of all kinds have found that internal auditing services can be utilized by management at all levels as an aid in managing the business more successfully. Many of our governmental organizations have also begun to utilize internal auditors to make audits and surveys of their own activities as an aid in managing these vast, far-flung organizations in a more effective and economical manner.

The use of internal auditors is not particularly new. One large industrial firm that I know of inaugurated its internal audit function about 50 years ago, in the year 1908. The growth of many of our corporations right after the first World War, particularly those with branches and factories in widely separated locations, fostered the establishment of internal auditing units. It was found convenient and practical to use internal auditors to be sure that cash, accounts receivable, inventories as well as other assets would be properly accounted for. As the need for auditing services increased, the work of the internal auditor often complemented that of the public accountant in order to reduce the over-all cost of auditing work. The internal auditors' work during this period was strongly slanted towards the protection of the company's assets. While its scope varied somewhat from company to company, the work performed was primarily in the financial and accounting areas.

During the last 10 years or more internal auditing staffs have been gradually increasing the scope of their work in other areas. In quite a number of large companies internal auditing is used throughout the company as an aid to management to enable it to operate the business more effectively. As I mentioned previously the growth has been gradual. Generally it began through special auditing assignments in areas outside of the accounting or financial departments. As internal auditors found that their work was useful and appreciated by their companies' management, many of them started to work farther and farther afield so that eventually many of them finally were doing work throughout their companies.

In my own company, Lockheed Aircraft Corporation, the concept of our work is expressed in a statement included in our Administrative Manual. I would like to quote a portion of this statement under the heading "General Concept of Internal Auditing."

> "The department believes that the over-all objective of internal auditing is to be of assistance to all members of management—operating, as well as financial. It, therefore, is concerned with any phase of the company's activity, wherein it can be of service to management.
>
> "It renders this service by conducting examinations of accounting and operating organizations, and furnishing the various managers responsible for the activities reviewed, with reports, which contain objective analyses, appraisals, recommendations and pertinent comments. It conducts 'management' type audits. It is concerned not only with the verification of the accuracy of records but with the performance of various Company activities as compared with management expectancies. It gauges the significance of findings in the light of their effect on Company operations. It seeks to review activities through the 'eyes of management.'
>
> "It believes that 'internal auditors should not develop and install procedures, prepare records, or engage in any other activity which they normally would be expected to review and appraise.' However, it believes that it is proper for internal auditors to call attention to weaknesses in systems from a control standpoint, or to any other system deficiencies that affect the quality of performance. It further believes that it is proper to express an opinion as to the general direction that revisions of such systems should take, but that the details and installation of the revisions should be undertaken by others."

While I could talk at length concerning the progress of internal auditing during the past 10 or 15 years and its status at the present time, I think it would be both more interesting and informative to describe an advanced internal auditing system and tell you how it is organized; how it works; and describe some of the benefits that are obtained and the service it can render to management at all levels. As I am most familiar with our own internal auditing department at Lockheed Aircraft Corporation, I have chosen it as an illustration of just how modern internal auditing can be utilized.

Background

In order that you may better understand my description of our internal auditing department, I will tell you a little about Lockheed and how it is organized. It has three principal operating divisions. The first is the California Division located at Burbank, California. It designs, develops, and manufactures a variety of military and commercial aircraft. In the past several years, Lockheed, in common with many other large companies, has sought to diversify its products, so that it will not be so dependent on our Armed Services for business. As an example our California Division has recently secured an order to build an airline-like monorail system for Seattle's Century 21 Exposition.

The second of our divisions is our Missile and Space Division located in Sunnyvale, California. It is engaged in the development, design, and manufacture of missiles and satellites for the United States Government. The most prominent of its projects are the Polaris missile for the Navy and the Sentry satellite for the Air Force.

The third division is our Georgia Division located at Marietta, Georgia, near Atlanta. Its principal activity is the design, development, and manufacture of large aircraft for the Armed Services. One of its major projects is the manufacture of the Hercules transport. It has also sought to diversify its activities, and among other things constructed and now operates a large nuclear testing base at Dawsonville, Georgia.

We also have smaller divisions. Our service division has aircraft repair and overhaul bases at Ontario, California, New York International Airport, and at Honolulu, Hawaii. Our air terminal division operates the Lockheed Air Terminal at Burbank and provides fueling services at a number of other large air terminals. We have just begun to operate a new division, our Lockheed Electronics and Avionics Division now located at Maywood, California, and have recently acquired the Puget Sound Bridge and Dredging Company, located in Seattle, which builds and overhauls ships and builds bridges, dams, and the like. We are also beginning to manufacture small airplanes in Mexico by means of a new subsidiary.

Organization of Auditing Department

You can see by the description of Lockheed's activities that we have a variety to cover in widely spaced locations. Our Internal Auditing Department covers these activities by operating three units, one located in Burbank, California, one in Sunnyvale, California, and the other at Marietta, Georgia. Each of these units reports to me. I report to the Vice President of Finance.

We have at present 37 people in our Burbank Unit, 24 in our Missiles and Space Unit, and 24 in our Georgia Unit, or 85 in all. For example, at Burbank we have the Resident Internal Auditor, 5 supervisors, a secretary and one assistant to do clerical and typing work, and 29 auditors to do the field work.

At this point I might discuss briefly the place of the Auditing organization in the company. As mentioned above we report to the Vice President. In a survey conducted recently by the Institute of Internal Auditors it was found that by far most chief auditors reported to the Controller. Some report to the Treasurer or Vice President-Finance; others to an executive committee, to the President, or even to the Board of Directors.

In my opinion the auditing department should report near the top of the organization ladder so that the auditors will have backing. However, it should report to some executive that has time enough to give them a little help when they need it and an audience when the auditors feel called upon to sound off about some matter. In most cases it is difficult to deal with the Board of Directors informally. I know one prominent general auditor that has to go to the Chairman of the Board to have a travel order signed or an expense account approved, as he reports to the Chairman. Such a procedure presents problems. Often the President is too busy to give time to the General Auditor. If the company's controller is really one in fact and not merely the chief accountant, I think the auditors have some advantage in reporting to him. For one thing, he understands their language, their techniques, and is sympathetic to their problems. While he generally is a very busy man he probably has more time for their problems than someone farther up the organization ladder.

I now will describe the manner in which we plan and execute our work at Lockheed and some of the benefits which accrue to management at all levels in our company.

Program

In order that our work will be done in an orderly fashion and so that we will review all activities which we should, we provide long-term and short-term programs. The long-term program covers a three-year period while the short-term program covers a one-year period. Our long-term program is based on the company's organization chart. In developing our program we use the chart together with statements of functions and responsibilities for all organization units. By reviewing the chart and statements we determine which units should be included in our program.

In making all examinations and reviews, the question we try to answer in each case is, are the people responsible for the activity under review doing a good job? Of course if they are not, we try to find out why not. It does not matter whether we are reviewing an account in an accounting department or whether we are reviewing some inspection activity in the factory, the question is the same. Are they doing a good job?

All of this in an organization as large as ours, entails a good deal of work. For that reason we make some of the reviews every year, some every other year, and some every third year. The frequency depends upon a number of factors, some of which are: the importance of the activity, the extent of problems which would result if the activity got out of bed, and our past experience in reviewing it. So we include in our three-year program all activities we plan to review in a three-year period and indicate in which year or years we plan to review them.

We also include in our program estimates of the time required to perform each review, so that we can estimate our manpower requirements for each year, as well as for the three-year period. These estimates also are used as time standards to control time spent on each job and as a means of measuring our progress through the three-year program.

At this point you might ask, for example, how can we, as internal auditors, have a competent opinion whether or not the engineers have designed a good airplane. We of course are not expected to give such an opinion and we try to avoid making appraisals where there may be doubt of our technical competence.

However, in engineering departments as large as those required in present day aircraft companies, engineering management must have quite a good set of controls so that they can tell how well their own organizations are getting along. So we just examine their controls, making such tests as we think necessary. Aside from conformance to their own and company policies and procedures, we can examine such things as adherence to schedules, to quality control standards, and to budget limitations. We of course can review their records and reports to be sure they are timely, accurate, and complete. Yes, there is a good deal of work the auditor can do in the engineering departments and be helpful not only to top management but also to engineering management.

Again we do not examine directly a manufacturing department engaged in shearing and forming sheet metal. There are control departments (such as manufacturing planning, scheduling, material control, production control and inspection) to control manufacturing activities such as metal shearing and forming. We can examine their procedures, records, and reports to determine whether manufacturing activities are proceeding as planned. We also class in the control category such activities as industrial relations, plant protection, hours control, time standards, and production forecasting and scheduling. Of course we also examine such departments as traffic, receiving, purchasing, transportation and the like.

You can see from the above that in the field of operations we largely restrict our efforts to the control activities. In addition, of course, we review any custodial activities which are the responsibility of operating people.

At this point I should mention that we do not neglect the accounting or financial activities and a substantial part of our work is done in those fields. In our company, however, as in most other large companies, such activities are well organized and procedures relating to accounting and finance are sound and are generally pretty well adhered to. This is not always true of procedures, records, and reports prepared in other company organizations because in many cases, systems of checks and balances, as we find them in accounting, are too expensive to maintain. Furthermore more people in these organizations do not have the training and background to appreciate the need for a satisfactory degree of accuracy, so they may keep poor records and prepare inaccurate reports.

Audit Work

I would like to talk a little now about the way we do our work. The investigative or field work is performed by our auditing staff. It consists of in-charge auditors and assistants. The work is supervised by an audit supervisor, who sees that the work is properly started, controlled during its progress, and properly completed. Each supervisor has generally from four to six examinations or reviews under his supervision in various stages of completion. The in-charge auditor writes the report and the supervisor reviews the supporting working papers. The report itself is written to be read by quite a number of management people, ranging from some who are quite familiar with the work, to others who have only a very general knowledge concerning the activity reviewed. In order to be intelligible to such a variety of people, each report contains as much background information as we think necessary to make our findings readily understood. It also describes the purpose and scope, and our findings, our opinion in light of our findings, and any suggestions we may have for corrective action needed.

After the rough draft of the report is reviewed and edited by the supervisor, the in-charge auditor and the supervisor review it thoroughly with our "clients," naturally, the supervisors and managers of the activity we have examined. The review begins at the level actually doing the work and follows the chain of command to (at least) one or two steps higher than the level required to take action. We talk to the man concerned with our findings before we talk to his boss; we are extremely careful to be objective and fair and to tell the whole truth instead of some part of it. We secure agreement on the facts contained in our report before we complete our reviews, and while sometimes we may not secure agreement with our opinions, we listen carefully to the opinions expressed by the clients. If the point is a very serious one and of considerable consequence, we may give the client's opinion as well as our own in the report.

The reports are released simultaneously by the general auditor to all persons receiving them. The first page of the report consists of a distribution sheet showing all persons to whom the report is sent, and telling why the report is sent to them—for example, because we believe they should take corrective action; to be sure that some of their subordinates take corrective action; or merely for their information. The distribution sheet also indicates which of the persons receiving the report had the opportunity to review it in draft. Furthermore, it tells any of the persons asked to take action, to write a reply within 30 days describing the action taken. These letters are addressed to the Vice President-Finance with copies to the general auditor and resident internal auditor. If corrective action cannot be taken within such a short period, a letter must be written to the same persons estimating when corrective action will be completed. A final letter must then be written after the corrective action has been completed.

Each operating division has established its own follow-up and review system to be sure that timely and satisfactory corrective action is taken. The Auditing Department also follows up the reports to be sure that replies are received so that its files may be closed, and reviews the action taken in connection with each report in behalf of the Vice President-Finance to be sure that the action taken seems likely to cure the deficiency reported.

In order that the Internal Auditing Department may practice what it preaches with respect to control, it keeps records and prepares reports regarding its own operations, and makes comparisons of work accomplished against work planned. One report that it prepares is a weekly status report for projects in progress, showing status of each one, a comparison of man-days required with man-days allotted in our program, and expected completion date. Another is a quarterly report showing, among other things, our progress measured against the work for the year and against our long-term program.

Summary

The foregoing is an outline of the work of the Auditing Department, what we are trying to do, and how we are organized to do it. In addition to our regular programmed work, we also perform special reviews at the request of others in the company. This may take the form of reviews of company activities or reviews of records of vendors and other outside firms in connection with price redetermination proceedings and the like. This special work is usually of considerable volume requiring something like 25 per cent of our available time.

Management Reporting

I understand that the theme for this session is "Management Reporting." I do not think it is necessary to discuss the need for accounting and financial reports as you are all familiar with them and are fully aware of their importance and value. I would, instead, like to talk to you about the importance of other management reports and just how the internal auditors can help to make these more useful to the management in its day-to-day operation of the business. The reports I have in mind are those developed by sales, personnel, engineering, material control, production control, inspection departments and the like. Reports in these departments of course must be developed from source data which is generally recorded in some form of record. Of course such data may be recorded on tab cards or electronic tapes if electronic data processing systems are employed.

Records and reports in these operating units are just as important and often more important than those stemming from the accounting records. They supply information to management so that it can decide such things as: what to buy, how much to buy, and when to buy it; what and how much to manufacture; when to manufacture it; how many people to hire, what kind, and when to hire them. Management requires a continuous flow of data of this kind so that it can make sound, timely decisions. If this data is inaccurate and not furnished in time, management may make costly mistakes.

For example, in many manufacturing concerns that require a great variety of manufactured and purchased parts in manufacturing their products, it certainly is vital to minimize the number of parts shortages. Too many shortages will result in production delays, in the installation of parts out of sequence, and other costly practices. In order to reduce shortages to a minimum, it is necessary that parts are provided at the right time and at the right place.

Material control, purchasing, and production control departments are generally concerned in conducting their operations in such a way as to reduce parts shortages as much as they can. All of these departments prepare reports indicating the number of shortages in the areas they are responsible for. It is very important that these reports are timely, reasonably accurate, and complete. Here the internal auditors can review and appraise the procedures used in preparing reports, and by making suitable tests can determine whether they meet satisfactory standards of timeliness, accuracy and completeness. It is highly important to management that such records and reports meet these standards. If they do not, timely corrective action may not be taken and future delays and losses are almost certain to occur.

As another example I might cite reports issued by inspection departments. These must, of course, meet the same standards: timeliness, accuracy, and completeness. Management needs to know promptly if the number of rejected parts are increasing; whether or not serious defects are reported upstream and corrected at their source so that they will not recur with the attendant cost of reworking or making new parts. The internal auditors can be very helpful in reviewing inspection records and reports to be sure they meet company standards.

It might be asked just why the emphasis on these operating reports. Cannot operating departments prepare them promptly, accurately and completely? Certainly they can do so. I touched on this point previously and said that such organizations cannot maintain systems of checks and balances such as you find in accounting and financial organizations because the cost would be too great. Also many people in these organizations do not have the training and background to appreciate the need for a satisfactory degree of accuracy. Sometimes you may even find that such reports are altered in order that some activity may be placed in a better light than is warranted by the facts.

Good operating reports are essential so management can manage effectively. The internal auditors may be extremely helpful in insuring that such reports are reliable, so that management can utilize them to make sound decisions regarding necessary corrective action as needed.

Things We Have Learned

We have been developing the plans, techniques, and reports we are using for nearly 15 years. Over this period of time we have learned some things, things which have made our job easier and which have made our work more successful. Some of these matters are not particularly new but they seemed to be important to us in getting our job done in a satisfactory way. These deal with matters such as what sort of working climate do you need? How much backing should you get from top management? What kind of staff and supervisors are needed? And what sort of training is required to do auditing throughout the company?

Working Climate

I will talk first about working climate: what sort of an atmosphere does the auditing department need to do its work properly? First of all is independence; auditors must be free to say anything in their reports that needs to be said without pulling punches. This does not give the auditors license to be rude, tactless, or inconsiderate in their report language. In my opinion, you can say anything and criticize anyone at any level if you say it properly.

I am very proud of the fact that our management has given us a very high degree of independence and never in my knowledge have they tried to tell us what we should or should not say. I am sure that in spite of our intentions, we have at times said things which we might have said in a better way, but our management evidently felt that to be the most useful *we had to be independent.*

Backing by Top Management

In addition to independence, the auditors will need top management backing. I mean by that the auditors will have to have free access to all company departments, will be free to talk to all company people at any level in carrying out their work. Along with this, of course, is access to all company records, correspondence, documents, and the like.

In the matter of backing, all organization units will take their cue from top management; if it backs the auditors, all the others are likely to be cooperative. But if some department head goes to the president and says "Will you keep those auditors out of my department? I don't need them and I don't want them investigating my department." If the president agrees, he has given quite a blow to the standing of the company internal auditors and to their morale as well. So the auditors need the backing of top management.

Staff Required

If your company should undertake to make operational audits and reviews such as I have described, you should have very good people for your auditing staff. They must be well-trained by schooling and experience in auditing and accounting. They must have the ability to adapt themselves readily to unfamiliar situations and to assimilate knowledge quickly concerning unfamiliar procedures. Obviously they must be intelligent and possess good judgment. They must have good personalities, enabling them to get along well with all kinds of people, and must be able to view all matters objectively. We find that people who get along well with others, and who are able to inspire a sense of trust and respect, are well liked throughout the company. You may ask, is it necessary that auditors be liked? Well, no, it is not, but it certainly helps. If people like you, they are likely to cooperate with you and their cooperation will save you time and your company money.

We have secured about 60 per cent of our auditors from the public accounting field. The remainder have been trained by us or have received their training in internal auditing with other companies. We find it much better to hire people who are well trained in auditing and accounting and teach them the things they need to know about our factory activities. We have been singularly unsuccessful in teaching auditing techniques to industrial engineers and other people familiar with production activities.

The supervisory personnel of your auditing department should, of course, have all of the favorable qualifications discussed above and in addition should be enthusiastic about the possibilities of their work. They should be good salesmen for their department in a quiet sort of way. Their best sales efforts, of course, should be the work their department produces and the respect and confidence its people inspire as they go about their work.

In the kind of work we do we have found it desirable to have more seniors or in-charge auditors on the staff than assistants. This is somewhat contrary to the practice of public accountants who have proportionately more assistants.

Training

While we have our staff attend special courses in training, say report writing, from time to time, and we train our people in the newer techniques such as statistical sampling, by staff lecturers, our training for the most part is on-the-job training given by our auditors and supervisors. I might mention that during the past several years we have made a study of special techniques in auditing required in connection with electronic data processing machines and in that connection sent some of our men to the IBM school to study programming.

Report Writing

If the auditor's work is to receive the attention it deserves, he must write good reports. The reports must be clear and concise, and as interesting as they can be made. In our reports, we describe not only the things that are bad, but also the things that are good. Many auditors believe that you should report only deficiencies—things that are wrong. We do not believe that this is the best policy. For one thing, you cannot be completely fair if you only talk about the deficiencies. For example, in reviewing a certain activity you may find one important thing wrong and say so. However, there may be 10 or 12 others, just as important, which are in excellent condition. By mentioning only the deficiency, management may get a very distorted view of the operations of this particular activity. In other words, your report lacks perspective.

Also, it is much more difficult to get along with "clients" if you continually talk only about troubles, the things that are bad. The auditor as an appraiser or critic is in a difficult spot in maintaining good relations with the other company organizations. We believe that if he succeeds in being fair, his relationship with "clients" is greatly improved. So we believe in relating *all* the facts in our reports and in describing both the good and bad things we find during our work. It enables management to make sounder decisions and helps us to improve our relationships with other company people.

Conclusion

In conclusion, I have tried to show you by describing internal auditing operations in my own company, how it used modern internal auditing as a management tool. Obviously our methods could not be utilized in other aircraft companies unless they were modified somewhat to adapt them to different organization plans and operating conditions. In other industries, they would have to be modified even more.

It has been my hope that by this description I have given you an illustration of the progress of internal auditing. It is certainly a contrast with the type of auditing generally performed 15 or more years ago which, almost exclusively, was concerned with a review of the accounting and financial records. Our management likes this type of auditing and believes that audits and reviews of control activities throughout the company, in the manner described, are worthwhile and more than pay their way.

REPORTING FINANCIAL DATA TO MANAGEMENT, STOCKHOLDERS, AND EMPLOYEES

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When Mr. McCoy approached me a few months ago to participate in this year's Ohio State Institute on Accounting, I was particularly impressed with his comment that "we like to think of our program as forward looking, and we encourage speakers to deal with the broad, basic issues of the future." It is within such frame of reference that I would like to address you this afternoon—looking back into the past only to try and find guideposts which might help us constructively to meet the many challenges of the future successfully.

In presenting certain of my views on the reporting of "Financial Data to Management, Stockholders, and Employees," I would like first to talk in the area of reporting financial information to management, and then subsequently deal with the stockholder group, and finally, employees. Obviously, the goals of financial reporting to each group are somewhat different, and hence the treatment should vary accordingly.

I would like also to discuss this subject from the viewpoint of what the *accountant* can contribute to the successful reporting of financial information—both the internal or company accountant, and the outside or public accountant. Each group faces many challenges and opportunities in this area, and each has special opportunities, training, and capabilities to accomplish the effective reporting of financial data. The company accountant knows in detail the company structure, its policies, its management personalities, its products and their problems of production and distribution, the internal reporting problems and procedures, and the many complex interrelationships between functions and departments.

On the other hand, the outside or public accountant has a more detached, objective, and independent viewpoint, and also has the benefit of experiences arising from working with other companies. In recent years, many public accountants have also branched strongly into areas of management services other than such traditional services as auditing, tax service, and the preparation of financial statements. The American Institute's Committee on Management Services by CPA's published a report in October, 1957, outlining the many management services now being offered in varying degrees by CPA's and the list was indeed most impressive and gratifying. I recommend this report for your attention if you have not already seen it. By equipping themselves to serve in these various areas of management services, the CPA's place themselves strongly in the forefront of those who can help management to meet successfully the competitive challenges of the future.

Finally, I would like to make it clear that in dealing with the concept of financial information, I am thinking of far greater horizons than just the Balance Sheet and/or the P & L Statement—or should I say, the statement of financial condition and the statement of operating results. Financial data also includes, in my definition, such information as forecasted plans of operations, capital expenditures, sources and disposition of funds, expense as well as income details, rates of return on investment, comparisons of actual results vs. budget, and all the other financial data of the business necessary to proper planning and control of the enterprise. Hence, particularly from the standpoint of such data to management, a system of communicating financial information takes on the character of a wholly-integrated, "total systems" type of plan built to satisfy adequately the needs of all echelons and functions of management, and their respective decision-making responsibilities. To a somewhat lesser degree because of less need for detail, simliar consideration should be given to the needs of stockholders and employees, depending somewhat on the type of company, size, how closely held, and other pertinent factors.

Communicating Financial Information to Management

There have been many written and spoken words on the subject of communicating financial information to management. The architects of effective management reports have stressed many important principles, such as promptness, accuracy, timeliness, clarity, brevity, and the very important need for tailoring them to individual preferences. I have stressed similar principles in my own operations and in public speeches. In doing so, I started out a number of years ago by creating a sort of memory-jogging type of gimmick called the 5 C's of good reporting. With additional experience and thought in this area, I have added to this list until now it has grown to the 8 C's of good reporting. No doubt other C's can and will be added, and any suggestions on further possible candidates to this particular Hall of Fame will be appreciated.

For those of you who are interested in this type of reminder, these 8 C's are as follows:

1. *Correct*—the report should be accurate within practical and needed limitations.

2. *Complete*—the data should contain all necessary items for performance, accountability, and decision-making.
3. *Concise*—the report should be as brief as possible.
4. *Clear*—the interest and meaning of the report material should be obvious.
5. *Comprehensive*—the report should go beyond just being complete by containing enough supporting evidence and auxilliary material to point out, for example, major implications, possible courses of action, supplementary interpretations, etc.
6. *Comparative*—actual data should be measured against standard, estimate, last year, industry data, or some other form of yardstick.
7. *Candid*—the report should be unbiased and completely objective.
8. *Considerate*—the report should have "empathy"—the personal touch—prepared so as to see the other fellow's viewpoint and appeal to him in order to make the report a "help to him," rather than "my report to him."

These principles of good reporting are important and will always be important to effective communications. Although I have spent many years in various accounting capacities, it has also been my privilege to spend some time as a line executive, and even today many of my responsibilities deal heavily with line operating problems. Therefore, having been on "both sides of the table" I can assure you that these principles of good reporting are not only important—they are absolutely essential if the responsibilities (and obligations) of acccounting service to management are to be met successfully.

Another comment which seems important in any discussion of reporting financial information to various levels of management deals with the distinction between a performance report, and an information report. Essentially all reports of financial and statistical information to management can be divided broadly into these two classifications. The distinction between the two is important because each serves different goals or objectives. The performance report, for example, is an accountability report. Its purpose is twofold:

1. It seeks to tell the reader how he has done in the areas for which he is directly responsible for performance. "How have I done?" is the yardstick of specific performance against budget, last month, last year, standard, planned goals, or other criteria.
2. It also seeks to motivate the reader to generate whatever direct

management action is necessary to improve performance. This could involve improving deliveries, reducing cost, bettering customer service, stepping up machine productivity or labor efficiency, or whatever other area is dealt with in the report.

On the other hand, information reports are, as the name implies, reports issued for the purpose of providing the reader with information relevant to his areas of interest but not necessarily directly associated with his specific responsibility for performance. Hence, information reports serve a broader and different set of goals than do performance reports. For example, some of the goals of information reports are as follows:

1. They are part of the communication system of the company to keep specified management levels informed on company progress and condition.
2. They provide management with the knowledge to do a number of things more skillfully, including:
    a. Greater participation in formulating company policies
    b. More intelligent participation in decision-making
    c. More effective suggestions to other management areas for improvement
3. They provide management with more of a feeling that they are part of a team—a sense of "belonging."
4. They motivate and stimulate management to exert more effort and creativity for the benefit of the enterprise as a whole.
5. They develop and broaden management for more important responsibilities.

These differences in goals and purposes between performance reports and information reports obviously have important influences on the construction of these reports in such areas as the amount of detail shown, the categories of information displayed, style of the report, factors emphasized, speed of its issuance, number of copies, methods of duplication, etc. It is essential that the accountant recognize these differences in an appropriate and effective manner.

One further thought on these two classes of report may be helpful. In the usual scheme of reporting financial information to management, more attention seems to be given to performance reporting, and less attention to information reporting. This difference in emphasis is understandable, and perhaps quite natural. The goals of performance reports and accountability requirements are more specific and tangible than the less tangible objectives of information reports. Hence information reports are frequently lacking where needed, or have poor distribution, inadequate information, poor composition, or excessively late timing.

In the short range, performance reports are probably more important than information reports because of the immediate and pressing needs to keep the business "on course." However, in the long range I would like to suggest to you that information reports are fully as important, if not more important, than performance reports to the progress and growth of the business. A close and thoughtful examination of the goals of each type of report, I believe, will soon reveal my reasons for this conclusion. And if you accept this conclusion—as I hope you will—then a careful examination of the structure, content, and frequency of report preparation of both classes of reports is in order to insure that an effective job is being done in both areas.

However, taking my cue from the encouragement to deal with broad, basic issues of the future, I would like to direct your attention to a number of other areas or concepts that tie in with such ominous-sounding terms as automation, integrated-data processing, operations analysis, electronic computers, scientific management, and operations research. During the past few years, tremendous changes have been taking place in our accounting, analyzing, and reporting capabilities. There is much more to come. Scientific management techniques for planning, forecasting, controlling, and optimizing operations have been developing swiftly under the pressures of competition for new and better products and services. These developments have been aided and abetted, and sometimes made possible and practical, by great strides in the development of many forms and types of machinery and devices for speeding up and taking the drudgery out of arithmetical recording, calculations, summations, and other record keeping and reporting procedures.

These items range from simple devices on typewriters and adding machines to huge electronic computers spilling out millions of calculations and comparisons in a few seconds of time. Hence, to be truly effective in our accounting and reporting responsibilities, we must take full advantage of these capabilities and concepts in channeling financial data to management. And because these fields are so new and big, and contain many ramifications and inter-relationships, it is more important than ever that *both* the inside or company accountant, and the outside or public accountant, draw on each other's capabilities and skills so that the best and most effective methods are established for analyzing and reporting necessary data to management.

Let us for a moment, then, look briefly at some of these tools which have been developed during the past few years—tools that give us tremendously increased capabilities in accounting service, analysis, and reporting. In fact, it should be emphasized that further developments on these tools are coming so fast that I am sure what is being said today will become obsolete in the very near future, lending even greater emphasis on our need to keep abreast of this changing field. It should be emphasized also that these tools are not the decision-makers, or an end in themselves. They are merely the means by which we can assist management through better and faster data to carry out their decision-making responsibilities more effectively.

One of the biggest of these tools—and certainly one of the most glamorous—is the electronic computer. It has given us capabilities for accurate, lightning-speed calculations, tremendous storage capacities with almost instantaneous accessibility, and very rapid printing of output data, or reports. These capabilities have completely revolutionized the horizons of communications, giving us wide flexibilities in the speed and sequence of report preparation, the depth and scope of report content and report distribution, the diversity of report comparisons and summaries, and the integration of reports to various echelons of management. There are many varieties and sizes of electronic computers, ranging from small and oftentimes special-purpose machines to giant, general-purpose digital computers with great capabilities of speed, storage, and output for performing almost any kind of business or scientific application. And for those companies too small to justify leasing or owning such facilities, service bureaus exist where machine time can be purchased as needed. These tools have vastly increased our capabilities for management reporting over the days of the pencil and desk calculator.

Couple these capabilities, next, with the new developments in peripheral equipment to these computers, such as the variety of input data machines, tape-to-card and card-to-tape converters, processed tapes as by-products of other operations, and high-speed, complex wire communication systems. These further enhance our capabilities for analyzing and reporting financial data in one form or another to management.

The existence of these types of tools encourages, in fact requires us to go deeper into such areas as integrated data-processing and "total systems" concepts of data handling and processing because we now have the capabilities to explore this field to its ultimate. Actually, the concept of integrated data-processing has been around now for quite some time, and there have been numerous applications of its principles, particularly in the shipping order, invoice, and payroll fields. And while such applications have been helpful and progressive,they have been hampered, until recently, because the right kinds of equipment just have not been available to carry these principles to their fullest use. However, we now have equipment capabilities with calculation speed, storage, and input and output flexibility that finally makes possible a complete "total systems" concept of data handling and processing. For example, a single writing of input data, such as a customer's order, can from there accommodate all management data requirements triggered by that order, including sales volume levels, credits requirements, production planning and scheduling data, manufacturing needs, loading and shipping instructions, traffic routings, transit billings, purchasing information, accounting entries, and management reporting at all levels. Functional lines are crossed and recrossed as the order flows through the areas related to its fulfillment. Departmental walls are knocked down as feedback flows to various functions from the common trail. We are, therefore, now looking at a "total system" serving the requirements of each function of the enterprise from a common source, rather than each function or department largely developing its own records and reports independently.

I also want to emphasize again that I am harboring no illusions that we have now reached the ultimate in capabilities for recording, analyzing and reporting various data to management for control and decision-making. I do not doubt for a minute that further strides in these areas will be made. Rather, I am emphasizing the great strides that have been made, and the urgent need for accounting management to pursue these possibilities intensely and completely lest the parade pass you by and leave you choking in the dust kicked up by your competition.

I want also to emphasize one other thought loudly and clearly. I am not so completely enamored with these machines and their capabilities to believe that some form of machine application is the answer in every case. It has been demonstrated many times that there are numerous areas of transmitting financial data to management where simple clerical routines are more effective, more timely and less costly. These might include such examples as daily reports of cash flows, shift reports of actual performance *vs.* standard, and daily sales totals. Properly analyzed and evaluated, such instances will show up clearly enough to justify this type of an approach. However, do not let these instances lull you into a false feeling of comfortable security. These instances in no way negate the tremendous possibilities for improved reporting which exist in many other areas as the result of improved tools and techniques.

Now let us add one more tool or concept to these thoughts, namely operations analysis and operations research. If we merely apply our present methods and procedures to these machines, we gain only part of the capabilities we might otherwise achieve. To reach the optimum, we need a searching, objective, unbiased, and thorough review of all departments' requirements in order to tailor-make this "total system" in the most effective and efficient manner. This means a complete overhaul and "re-look" at work flows, report and paper work, sequence of handling, extent of detail and summarized data, form design, form distribution, operating needs, inter-functional and inter-department relationships, and so on. And what is more important, this re-look should not be done *only* from the standpoint of streamlining the efficiency of our "figure factory." It should start from the standpoint of what are the basic requirements of *both management and the customer*, and what are the optimal methods that will best serve *both* of their needs. Too often we have been much too figure-oriented, or even too management-oriented. This may sound like a strange statement. However, all of us know that our company will be the most likely to succeed if we provide our customers with the best products, the best price, and the best service. Our own purchasing departments follow this same philosophy when we are the customer—or they had better follow it, or we are in trouble.

Hence, we need to find out, through these objective, operations analysis or operations research studies, not only what our management thinks they need for effective performance, but also what *the customer expects* in the way of product, price, and service. This immediately raises such basic questions as plant locations, quality control tolerances, transportation methods and transit times, sales service, and many other areas. We encounter the thorny problem of centralized *vs.* decentralized sales and production administration, accounting service, and so on. Maybe we are doing these things the best way now, but the "re-look" should be deep and penetrating and candid so that the "figure factory" and the reporting results meet the requirements of management and the customer in the most effective manner.

Now operations analysis can accomplish this "re-look," in fact, has done it for industry under various approaches identified as methods analysis, procedures review, cost analysis, management engineering, forms analysis, etc. Let us add to the methods of operations analysis, however, such mathematical and statistical techniques of operations research as linear programming, queuing, response surface analysis, multiple correlation, probability, and design of experiments. These and others like them are powerful tools which often can contribute exceedingly well to our total "re-look." Properly blended with our other concepts and analyses, we then have a thorough and forward-looking program that will bring our requirements to the right machines and equipment in a way that will optimize their capabilities and ours to provide all echelons and functions of management with the most effective financial and statistical data to manage the business and serve our customers.

The foregoing comments have dealt only briefly and broadly with certain major tools and concepts which have just within the past few years increased tremendously our capabilities for providing management with financial data to manage the business. To these can be added an impressive array of accounting techniques and procedures which have been refined and popularized since World War II. I am thinking of such techniques as direct costing, flexible budgeting, break-even analysis, and return on capital employed. They are all essentially a means of giving management better guidance on the financial relationships of the enterprise. Coupled with the expanded capabilities for financial reporting given to us by computers, integrated data-processing, and operations research, we now have at our command a tremendous array of tools, concepts, and techniques for developing an effective and efficient means of providing financial information to all levels of management.

Before leaving this area of reporting financial information to management, I would like to emphasize one further concept in which I believe very keenly, namely that our greatest service to management lies in providing them with the necessary data to *predict* results, as contrasted to an historical analysis of results. Up until now, my comments can easily be interpreted as falling largely in the area of accumulating the results of past management actions—doing so quickly, effectively, and on a well-integrated basis. To do this job well is certainly part of our responsibility; part of our function can be very well described as that of an "arithmetic historian."

However, you will recall that my definition of financial information included forecasted plans of operations. In this day and age of complex business transactions, we can no longer be mere historians of figures. We can no longer merely record and report. We must assist and encourage all areas of management to forecast, plan, and control to pre-determined objectives. We must apply our aptitudes, abilities, training, and experience to help guide the business to *pre-determined patterns of maximum profits.* Our communication of financial information to management must emphasize the *future effect* of decisions and plans. If we look ahead with sound financial planning, and provide our management groups with the necessary data to control to the goals of such planning, we will then be providing the kind of accounting service and business management to which our operators are entitled.

The importance of this area of prediction, and the contributions which computers can make to this area, is exemplified by the following quotation from an article appearing in *The Harvard Business Review* of March-April, 1954. The title of this article is "Electronics Down to Earth" and was written by Mr. Higgins and Mr. Glickauf. This article stated:

> "Although the advantages that will accrue to management through the use of computers are manifold, there is little doubt that the most significant impact of this whole new development is that the emphasis on accounting and reporting for business will change from one of historical reporting to one of reporting in terms of the future; and hence, on providing data for the formulation of reliable management judgments and effective management controls."

Please note that the importance is not placed on what electronics can do in the rapid accumulation of past data. Rather, the stress is placed on what electronics appears to offer in the field of planning, control, and forecasting of future events and future courses of action.

In summary, then, our accounting profession has been given tremendously increased capabilities during recent years in the areas of recording, analyzing, and reporting of financial information to management. There has been put at our disposal an impressive array of tools, techniques, and concepts, such as computers and peripheral hardware, integrated-data processing, operations research, and such accounting methodology as direct costing, flexible budgeting, break-even analysis, and return on capital employed. We face a tremendous challenge to blend all of these tools, concepts, and techniques into a hard-hitting, fast, effective, and efficient system of communicating financial data to management. Those of us who do the best job in these areas will give our managements a tremendous competitive advantage. Clearly, this is one of the greatest challenges facing us in the future. We must meet it vigorously and aggressively if we are to justify the faith and confidence which management has placed in us as the custodian and dissemination of financial information.

Communicating Financial Information to Stockholders

Practices in communicating financial information to stockholders will vary widely depending on such circumstances as the number of stockholders, who they are and where they are located, the nature of the enterprise and the industry involved, the extent of individual holdings, the governmental regulations pertinent to its securities, and other relevant factors. There is also the obvious situation that such reports to stockholders need not be made as frequently as they are made to management, nor in as much detail. Nontheless, a sound, practical, and adequate program of communicating financial data to stockholders is essential for the best interest of the enterprise, be it big or small, widely or closely held. As an illustration of a specific program for reporting such data, I would like to outline to you the philosophies and practices followed by General Mills in keeping its stockholders informed of our financial condition. In doing so, I do not submit that we are doing the job in the best and most effective way. Certainly also, there is no single way that is best for all companies. Company-stockholder relations are fluid and changing, and no one way is the best way for very long. Hence, it is very important to get "feedback" from stockholders as to how effectively communications are being established with them.

General Mills is a widely held corporation, with over 12,000 stockholders residing in all states of the Union, and in a number of foreign countries. As a matter of company policy, we strongly believe in keeping these owners informed as to the company's financial condition, and its financial progress. There are many good reasons for this policy:

> First and foremost, the stockholders are the *owners* of the business, and are entitled to periodic reports on the results of our financial stewardship.
>
> Second, our stockholders are also customers, or potential customers, for our products. The story of their company's financial condition and progress, coupled with appropriate news on company products and activities, should encourage them to support the use of our products.
>
> Third, our stockholders also are a potential source of additional capital. If they are well-informed and have confidence in the company's financial progress, their support for additional requirements of equity capital will be forthcoming.
>
> Fourth, our stockholders are, or can be, enthusiastic public relations representatives for the company. This can be helpful to the company's progress in many ways.
>
> Fifth, our stockholders, through understanding the company's financial position and progress, will be motivated in the direction of being friendly toward company management and its policies, if we deserve it.

> And lastly, our stockholders are citizens who should be motivated in every way possible to understand and support the American free enterprise system. Their belief in and support of our free enterprise system can be considerably strengthened through understanding such matters as the need to provide for wear and tear on buildings and equipment, the impact of taxes on earnings, the necessity for retained earnings, the importance of research, and other corporate matters which we so often take for granted.

Stockholders in General Mills are kept informed on the company's financial condition through a variety and number of channels. One of these is our Annual Report, published to all stockholders in the latter part of each July for the fiscal year ending May 31. Copies of our Annual Report are also sent to all employees, and to a large number of banks, financial editors, and others in the financial area. There is also a special mailing to non-employee officers of Unions representing our employees. There is also the usual press release to newspapers throughout the country, containing not only a summary of our financial status, but also explanatory comments by our President on the operating results for the year.

Incidentally, our results for 1957-58 were published in a rather unusual, two-part form: (1) a Sunday magazine supplement published in the Sunday edition of six major newspapers across the country, and (2) a financial section insert. The Sunday magazine supplement contained summary financial information, along with pictures and stories of the company's products, personnel, promotions, and other company activities. The financial section insert (which did not appear in the newspapers) contained further details of the company's financial results and condition. It was an unusual "first" in the publishing of Annual Reports, and we believe it was very effective.

Another means of transmitting company financial information to stockholders is through the annual stockholders' meeting. Here, presentations on the company's results are given to the stockholders by principal company officers, and ample opportunity is provided for questions and discussion. For many years, these meetings were held in Wilmington, Delaware, the site of our charter, but two years ago they were transferred to Minneapolis in order to encourage greater stockholder attendance. The increase in such attendance because of this move has been very gratifying.

Another and somewhat unusual method of communicating financial information to stockholders is through regional stockholder meetings. These were started in 1939, and generally have been done every two years since.

They were inaugurated through our then chairman of the board, Mr. James Ford Bell, who wanted "to bring the story of company operations directly to the stockholders since each stockholder is an owner and partner in General Mills." So far as we know, we were the first company to begin these types of meetings.

These regional stockholder meetings were essentially conducted along the same lines as our annual stockholders' meeting, except that they were conducted in 7 or 8 different areas around the country where reasonable concentrations of stockholders existed. Our company officers presented the year's results, and conducted question and answer sessions. While in the area, our company officers also met with financial analysts in the area in order to provide them with an opportunity to further question our officers concerning our financial condition.

During the process of conducting these regional stockholders meetings, another unusual feature was added, namely that several universities were also visited for the purpose of putting on a mock stockholder meeting for the benefit of the business students, and any others in the school who were interested. Some of these schools so visited have included the University of Wisconsin, Cornell, Yale, Harvard, Dartmouth, MIT, and Stanford. These meetings have proven exceedingly popular with students, and it has been very revealing to find the penetrating and intelligent questions asked by the students concerning the company's operations.

General Mills also publishes a 6-months' interim report to all stockholders. This report displays the results of operations for the first six months of the fiscal year, with a comparison to the first six months of the previous year. Appropriate comments on these results may also be made.

A final means of communicating financial data to stockholders is through the issuance of a magazine published solely for stockholders. The title of this magazine is *Horizons*, and I would like to quote from its published editorial policy:

> "General Mills' *Horizons* is published for the information of company stockholders. The company's philosophy is that an informed share owner will better serve General Mills in creating a favorable climate for the sale of stock, services, and products. He will constantly support management and its policies. Financial news of the company as well as stories on top personnel changes, introduction of new products, reports on the annual meeting and regional stockholder meetings, statements of company policies are included. Stockholders are invited to submit questions which are answered through the columns of the publication or by private correspondence."

From the standpoint of importance in transmitting financial data to stockholders, the fall issue of *Horizons* is the most important issue of this magazine since it contains a full report of the annual stockholder meeting, including not only the financial data but also the texts of addresses by company officers and directors. Other issues of this magazine contain articles from time to time on source and disposition of capital funds, trends in dividend payments, profiles of stock ownership, major new capital construction, and other vital and pertinent financial data.

The question and answer section of *Horizons* has proven to be a very excellent avenue for communicating financial information to stockholders. As stated in the editorial policy of *Horizons*, stockholders are invited to send in questions which are either answered in this section of *Horizons* if the questions seem to have particular universal appeal, or the questions are answered by private correspondence. The availability of this service provides stockholders with an established channel for learning about matters that for some reason or another may not have been transmitted from the company to the stockholders, and this has been particularly helpful in our stockholder relations.

Communicating Financial Information to Employees

The greatest asset that any business has is its manpower. To paraphrase a quotation I once heard, you can take all my plants and lands and other tangible wealth, but leave me my manpower, and I will have them all back again in a short time. And one of the greatest, if not the greatest, way of building strong and supportive manpower in an enterprise is through an intelligent and effective employee communications program with two-directional flow. By two-directional, I mean not only should employees be informed on matters that the company wants to communicate; the employees should be informed on those matters *they* want to hear about from the company. There are many facets, of course, to accomplishing a two-directional communication system, and many mechanisms involved in such a program, such as communication conferences, management development programs, plant meetings, an employees' suggestion system, house organs, exit interviews, personal "How Am I Doing?" talks, letters to employees, and so on. This is a big subject by itself, and I do not have enough time left to develop it any further except to emphasize its tremendous importance to the growth and progress of the enterprise.

In the communication of financial information to employees, we in General Mills have relied heavily on two media, namely (1) the company's Annual Report, which I have indicated earlier is sent to all employees, and (2) a monthly publication called *The Modern Millwheel*, which is a company-wide house magazine published for the information of General Mills employees and their families. Since I have already discussed our Company's Annual Report, I will confine my remaining remarks to this monthly publication.

The primary purpose of *The Modern Millwheel* is to inform, to do an educational job. At the same time, recognizing this two-directional flow of communications, it also serves as an outlet for employee expression and recognition. The *Millwheel* carries over-all company news including the latest developments at headquarters and company points, articles of broad interest to employees, financial information, statements of policy, and special features such as an employee question and answer service. Specifically, some of the things the *Millwheel* tends to do are:

1. Inform the employees about General Mills, its people, plants, products, and financial condition.
2. Convince the employee that he is an important part of the General Mills family.
3. Show why General Mills is a good place to work.
4. Provide information that will enable General Mills employees to be good public relations representatives for the company.
5. Help maintain faith in the American business system of profit and loss, and in the spiritual foundations of American life.

The August issue of *The Modern Millwheel* always contains a dominant article highlighting the key factors of financial information in the published annual report. Hence, the employee not only gets a copy of our annual report, but at approximately the same time the employee also receives similar information through the pages of the *Millwheel*. Throughout the year, as warranted, other monthly issues contain various articles of financial interest. These are frequently tied to the self-interest of the employee by emphasizing that a profitable company is a good company to work for, since profitable operations help to insure continuity of employment, expanding job opportunities, and levels of compensation commensurate with their capabilities.

Conclusion

In closing, I would like to emphasize again that many powerful and far-reaching tools and techniques have been made available to the accountant for the reporting of financial data. Many of these tools are new, and there surely will be further startling developments in the near future. It is, and will continue to be for a long time to come, a tremendous challenge to our accounting profession to mold and blend these tools and techniques into a smooth-functioning, forward-looking, and effective system for communicating financial data to management, not only for historical reporting and analysis, but more importantly, for purposes of management planning, forecasting, controlling, and other areas of management decision-making.

At the same time, the accountant must also thoroughly recognize the important goals to be served in providing stockholders and employees with adequate financial information, and work closely with other management groups within the company to insure that these goals are met as successfully as possible. As I have tried to point out, such a course of action is vitally important not only to the immediate interests of the company, its stcokholders, and its employees, but also to our economy and our American way of life.

FOURTH SESSION

THURSDAY, MAY 21, 7:00 P. M.
The Ohio Union—East Ballroom

Presiding:

DR. WALTER C. WEIDLER, *Dean, College of Commerce and Administration, The Ohio State University*

Greetings:

DR. RONALD B. THOMPSON, *Executive Dean, Special Services, The Ohio State University, Columbus*

Paper: "Let's Take Another Look at Competition"

DR. WILLIAM A. PATON, *University of Michigan, Ann Arbor, Michigan*

Presentation of the distinguished accountant elected to the Accounting Hall of Fame, by

RUSSELL H. HASSLER, *Chairman of Board of Nominations, Professor and Associate Dean, Graduate School of Business Administration, Harvard University, to*

MARQUIS G. EATON

FOURTH SESSION

Hall of Fame Banquet

Chairman Walter C. Weidler: Honored guests, ladies and gentlemen: From time to time, it has been my privilege at these conferences to report on curricular and course developments both off and on this campus, which have had significant impacts on collegiate business education in general, and on accounting in particular.

Many of you will remember that this University undertook some four years ago to make a searching study of the provisions for general education in the Colleges of Agriculture and Home Economics, Arts and Sciences, Commerce and Administration, Education, and Engineering. A committee, consisting of a representative from each of these five undergraduate colleges, with chairman Vice President Heimberger, subjected all of these programs to critical review. Indeed, it was Vice President Heimberger who really sparked this study. I must also observe that Jack Fullen, our dynamic Alumni Secretary, shared these concerns for general education.

This committee of five, frequently referred to as the Heimberger Committee, worked closely with the Colleges and with the University's Council on Instruction.

As a result of all these things, the Faculty Council, our University's legislative body, adopted this past year a pattern of requirements for general education which apply equally to the programs of the five undergraduate colleges. These common requirements for general education provide for a minimum of 15 quarter hours of work in each of the three basic areas of academic study, namely, the Humanities, the Social Sciences, and the Natural Sciences.

The objectives to be sought are set forth quite succinctly in the following excerpts from the official report. I quote:

"Humanities. The objectives are to introduce the student to the possibilities for continuing growth as a thoughtful and reasoning person, sensitive to the aspirations and attainments of others; to acquaint him at least in some degree with the treasures of human thought and expression at his command; and to develop in him a continuing desire to have his full share of the legacy of all creative efforts.

"Social Sciences. The objectives are to make sure that the student has at least a basic understanding of the fundamental ideas upon which our society has been built, the social institutions through which these ideas have been given effective meaning, and the never-ending process of development through free choices limited only by concern for the rights and well-being of others. Emphasis will be put upon the values of a free society and the responsibility of the individual for participating actively in the issues and decisions of the day.

"Natural Sciences. The objectives are to acquaint the student with the kinds of problems which lend themselves to possible solutions through the use of science, to introduce him to differing scientific techniques through significant illustrative experiences, to give him a sense of perspective in the development of science, and to develop in him an understanding of the basic community of all scientific disciplines.

"Each undergraduate curriculum has been constructed to include a minimum of 45 credit hours designed to translate these objectives into course patterns."

When the Committee of Five was first organized, the College of Commerce and Administration decided that the time had come to subject all of its programs to critical examination, not only with reference to the provisions for general education, but also with reference to their validity from the standpoint of vocational and professional education.

To this end, our College Committee on Instruction was reorganized. Its membership was made more representative and the charter of responsibilities was broadened. The Chairman of this important Committee was our own Professor of Accounting Paul Noble, who is, as you know, the Dean-elect of the College of Commerce of Ohio University, his old school.

Long before the Committee of Five had completed its work, and before the Faculty Council action prescribing a minimum of 45 hours of work in the Humanities, Social Science and Natural Sciences, our College had already made notable changes in our curricular patterns to make a larger place for general education.

For example, it was determined that practically all of the student's time in his first two years was to be devoted to general education, only 15 quarter hours, or less than one-sixth, being essentially vocational in nature. We had added an advanced course in English Composition to our requirements. We had prescribed a minimum requirement of six hours in the humanities. We had adopted a common pattern of general course requirements for the Freshman and Sophomore years, so that students were no longer required to define a field of major interest until the beginning of their Junior year.

We had also reorganized our programs to give increased emphasis to general business education. We had reduced the amount of course work required in the student's fields of special interest, with a collateral increase in the number of free elective hours available to our students in their Junior and Senior years.

Perhaps I should pause at this point to observe that in all of these things the College has had the most cordial and sympathetic cooperation from its Accounting Department.

I have already referred to Paul Noble's part in this enterprise. Paul was succeeded in the chairmanship of the College Committee on Instruction by another very able accountant, Paul Fertig, who succeeds Professor James McCoy in the Chairmanship of our Accounting Department.

The principal changes made in our programs in this past year have been to increase our humanities minimal requirement from 6 to 15 quarter hours to comply with the directive of the University Faculty Council. Perhaps I should observe that our Commerce students may satisfy the humanities requirement by electing courses in classical languages, in comparative literature, in English, in philosophy, fine arts, speech and music. I might also observe that our College social science requirement is 35 and not 15 quarter hours, the prescribed minimum.

Our Accounting Department has been engaged this past year in a searching study of its introductory course work to determine its validity from the standpoint of general business education. The immediate result has been a reduction in the required course work in accounting for non-accounting majors from 15 to 10 quarter hours. Continued study of this problem and our experimental approach will, we hope, result in increased educational values.

It should be noted that the entire program of the Accounting Department is now subject to intensive study. Developments in the field of data processing and applications of mathematics to decision making, keep our attention focused on our mathematical requirements.

Indeed, our concerns at this point involve the mathematical education and orientation of both faculty and students. There is, I believe, a very widespread realization that there is a very real educational job to be done with faculty, if our teaching and research are to profit from the developments referred to above.

As instruments of faculty education, we have encouraged faculty seminars on data processing. In these endeavors the Accounting Department has taken the leadership.

As many of your may know, the Ford Foundation, alerted to the need for faculty education in this important area, has set up a program in basic mathematics in cooperation with Harvard and M.I.T. This program will fully engage the time and energies of its enrollees for a 12-month period beginning in September of this year. Provision was made for 40 enrollees. You can, therefore, well imagine our pride and delight when this College was accorded three of these coveted places. Thus three of our brilliant young faculty members will spend a year in this enterprise, and will return at the end of the year, not only better equipped themselves, but also through seminars and personal contacts, they should contribute to the further education and understanding of their colleagues.

Another of our staff will spend a month this summer with another faculty group, studying and exploring, among other things, the contributions of mathematics to decision making.

In all of these things the College has had the most cordial and understanding support from the University administration and from its Board of Trustees.

If memory serves me right, I once told the members of this Accounting Institute the story of Professor Joe Taylor and young Boris Sidus. May I be pardoned for repeating the story at this time.

Back in my youth there was on the faculty Joe Taylor, a professor noted for his wisdom and for his wit. About this time a young man by the name of Boris Sidus had blazed a trail across the academic firmament. He got his Ph.D. from Harvard at 18 years of age. One of Joe Taylor's colleagues was bragging about Boris Sidus' accomplishments, and said, "Just think, 18 and he has his Ph.D. from Harvard. Just think of his accomplishment—of his future."

Joe Taylor said, "Yes, I am thinking of his future. But I am afraid that maybe young Boris Sidus has his future behind him."

By way of contrast, I am pretty sure that this Accounting Department of The Ohio State University and this College do not have their futures behind them.

The fine support of the University administration, the cooperation of its Board of Trustees, an able faculty devoted to good team work, a young and vigorous new Dean, all augur well for the future of the enterprise.

In closing, may I tell you how deeply I have treasured my association with you in this Institute over these many years. May I express our appreciation for the splended cooperation we have always had from you and from your associations. May I thank each and every one of you who have or who will contribute so effectively to this Institute program.

And may I tell you in closing how very happy I am that my good friend and colleague, James McCoy, is to succeed me in the Deanship. I have followed his career with abiding interest and deep affection. I shall always think of him as one of my boys, albeit a man of stature and high abilities.

I wish now to introduce those at this speaker's table. (Introductions)

I come now to the introduction of an old friend of mine, a fellow administrator, Dr. Ronald B. Thompson, Executive Dean for Special Services of The Ohio State University. I do not know what that means, except it means he has a whale of a lot of things to take care of in this institution. If he occupies anything, it is not a seat; it must be a settee. Ronald is a very able mathematician and an educational statistician, and seems to make uncannily accurate forecasts of student enrollment.

Dean Thompson will bring you the greetings of the University.

DR. RONALD B. THOMPSON: Thank you, Dean Weidler. Honored guests at the head table, and honored guests in the audience, because this is an audience of honored guests.

It is good to welcome such a group as this to The Ohio State University, and to represent this University on an occasion such as this, and to welcome you on behalf of President Fawcett, who could not be with us this evening, and bring you greetings from the entire University family.

The Ohio State University is much like any individual who has many varied interests and activities. The Department of Accounting here is one of our 22 teaching departments, in our 10 colleges and 9 schools in combinations offering some 250 different programs of study which constitute a broad range of activities offering educational opportunities to those students who are sent to us that they may prepare to live in a complex society such as we have.

This University is one of constant growth, maturity and development, and it has occurred to me, in trying to give you an illustration of this growth, maturity and development, to tell you that over by the Administration Building we have a glowing example. To the west is University Hall, housing our College of Arts and Sciences. University Hall was, of course, at one time *the University*, housing all the activities in the University. Located in this building were the faculty offices, administration offices, the classrooms, faculty housing, student housing, dormitories, eating facilities, and all the facilities which at that time took care of almost 100 students. But those people who built this administration building had vision, because they had prepared for a University of 400 students, and perhaps more. Now they were preparing for four times as many students as we had on the campus at that time, but anyone who would say we are preparing for four times as many might be optimistic in the comparison of growth, development and maturity.

To the northeast of the building is the new College of Arts and Sciences. It, along with other facilities under construction, will make possible the expansion of programs now established under the development of new techniques and research. Many programs and activities on this campus are either new or are of long standing.

It is interesting to note that this meeting tonight is your twenty-first annual Institute of Accounting. You have reached maturity, voting age, now. And the University likewise has reached maturity. It is long forgotten, the original designation of the college in the cornfield. It is past that period of rapid expansion, and it has developed into one of the really great universities of the world, giving recognized leadership in graduate education, professional education and research. We are truly glad to be a part of the Institute, which is another indication of the stature of this University. You honor us by holding the Accounting Hall of Fame in the Union Ballroom. It is good to be here and be one of you. Thank you. (Applause)

CHAIRMAN WEIDLER: Thank you, Dean Thompson.

We come now to the presentation of the distinguished accountant elected to the Accounting Hall of Fame. Dean Russell H. Hassler, Chairman of the Board of Nominations, will read the citation. Dean Ronald B. Thompson will confer the award and present the certificate. Mr. Donald R. Eaton will receive the certificate for his brother, Marquis.

DEAN RUSSELL H. HASSLER: Marquis G. Eaton combined the skills of a successful practicing accountant with those of a far-sighted student of our business and economic life.

Mr. Eaton attended Wentworth Military Academy and New York University's School of Commerce, Accounts and Finance. He served as an officer in the United States Army in World War I.

During most of his professional life he was a partner in the firm of Eaton and Huddle, San Antonio, Texas.

In his service to his profession, Mr. Eaton was president of the Southern States Accountants Conference, the Texas Society of Certified Public Accountants, and in 1956-1957 was president of the American Institute of Accountants. He served on many of its committees, and was active in advancing the development of continuing education programs and in improving relations with other professions.

Mr. Eaton made a distinguished contribution in his writings. He was one of the editors of *The C.P.A. Handbook.* In his article on "Financial Reporting in a Changing Society," his forward-looking ideas and breadth of approach were favorably received by leaders in all fields.

In March, 1959, the first C.P.A. Medal bestowed on a winner of the American Institute Award was conferred posthumously on him.

For leadership in his profession and for his role in guiding the profession to meet its opportunities and responsibilities to the world in which we live, the Board is happy and proud to present Marquis G. Eaton.

DEAN THOMPSON: Thank you. It just occurred to me that perhaps you would like to know what this citation says concerning this award.

"The Ohio State University Accounting Hall of Fame. Be it known that Marquis George Eaton, having made distinguished contributions to the advancement of the accounting profession, has been elected to the Accounting Hall of Fame of The Ohio State University. Upon the recommendation of the Board of Nominations, and in evidence thereof, this testimony is presented this 21st day of May, 1959." Signed by Russell H. Hassler, Chairman of the Board of Nominations; James McCoy, Chairman of the Department of Accounting; Walter C. Weidler, Dean of the College of Commerce and Administration; and Novice G. Fawcett, President of The Ohio State University."

It is then a privilege on behalf of the University and under the authority of its Board of Trustees, which makes this award possible, to make this presentation.

MR. DONALD R. EATON: Thank you. When I received your kind invitation to be present at this meeting, I was relieved to know there was to be no speech of acceptance from me, but I would like to express to you our sincere thanks for the honor you have shown our partner and brother.

CHAIRMAN WEIDLER: We come now to an assignment that is exceedingly pleasant for me, the introduction of an old friend as a speaker this evening, Professor William Andrew Paton of the University of Michigan. I decided to discard the biographical material which I had in hand and to simply read you the statement which I like so much, and which was read when Professor Paton was inducted into the Accounting Hall of Fame. It read as follows:

"An inspiring teacher, a notable author, and one whose leadership has been a real force in the development of accounting theory, Professor Paton was one of the early members of the American Association of University Instructors in Accounting and has served as President and Research Director of the American Accounting Association. He has been a member of the American Institute of Accountants' Committee on Accounting Procedure continuously since its establishment. He is the author or co-author of numerous accounting texts and articles. In his writing and teaching he has made a significant contribution to the development of realistic economics and to the formulation of accounting principles consistent with that concept."

I do not remember whether it was on that occasion or not that I said this in introducing Professor Paton:

"I feel a special friendship for him, for his Dean, Russell Stevenson, for his Prexy, Harlan Hatcher, for his college, for his University of Michigan with, of course, the usual November date line reservations."

Professor William Paton. His subject, "Let's Take Another Look at Competition." (Off the Record)

FIFTH SESSIONS

FRIDAY, MAY 22, 10:00 A. M.
The Ohio Union—West Ballroom

Presiding:

JOHN B. INGLIS, *President, National Association of Accountants; Partner, Price Waterhouse & Company, New York*

Paper: "The Accountant's Role in State Tax Administration"

STANLEY J. BOWERS, *President, National Tax Association; Tax Commissioner, State of Ohio, Columbus*

Paper: "Internal Inspections for Better Tax Administration"

HARRY J. TRAINOR, *President, Federal Government Accountants Association; Assistant Commissioner, Inspection, Internal Revenue Service, Washington, D.C.*

Paper: "Rulings and Federal Taxes"

PAUL YAGER, *Partner, Lybrand, Ross Brothers & Montgomery, Washington, D. C.*

THE ACCOUNTANT'S ROLE IN STATE TAX ADMINISTRATION

STANLEY J. BOWERS
President, National Tax Association; Tax Commissioner State of Ohio
Columbus

Mr. Chairman, members of the Institute of Accounting, and guests:

I am indeed grateful for the opportunity, honor and privilege of speaking before this group. I find myself somewhat handicapped, however, in that I know so many of you! It is easier to speak to a group far away from home where you are not known so as to qualify as an expert. During the period of a year I suspect that I visit and talk with more accounting groups in Ohio than any other professional group, but it is always a pleasure to be with you.

My remarks will be made from a brief outline and accordingly, extemporaneous. For this I offer an apology. My chief reason for not having a prepared paper has been occasioned by our legislature being in session which keeps me quite busy and, as you know, the tax program has had more than its share of publicity. In addition to this bona fide excuse, I dislike writing papers.

Referring to the remarks made by Mr. Inglis at the opening of this meeting, I am inclined to agree with him in the main. I believe everyone feels that taxes at the federal, state and local levels are too high. However, to be able to come here to the Students' Union and witness the activities at The Ohio State University permits you to see some of the good and desirable tangible benefits that come from the taxpayers' dollars.

Through the years, I have known personally and worked with our dearly beloved and departed friend, Dr. Maynard. It is also with regret that we must accept the retiring of Dean Weidler as a reality. Like Dr. Maynard, his record here at the University has been excellent. I know that everyone present is highly elated over the selection of our good friend, Dean-elect Jim McCoy. Under his able leadership, we can be assured that the Commerce Department of this institution will continue to carry on its work in the future as it has in the past.

The Department of Taxation works closely with the professors of this University in furnishing material which we publish. They regularly contact us for manuals, circulars and other data in the interest of getting the information to their students, particularly in the field of accounting and tax law.

In his introductory remarks, Mr. Inglis said that he did not know nor could he understand why a person would want to be a public official, particularly a tax commissioner. I, too, often wonder why anyone wants to be a public official, professor, teacher, preacher or social worker. It must be that many who dedicate their lives to this type of work feel that there is a greater satisfaction in serving than in receiving. I can also assure Mr. Inglis and those of you present that it is not difficult to be a tax commissioner. Almost everyone tells me what to do and in many instances, where to go!

In the following remarks, I have somewhat of an advantage in presenting my views of what I believe the accountant's role to be in state tax administration. I can say what I think and you can accept or reject it. At the conclusion of my remarks, if you wish to take issue, it may afford some discussion of controversial matters. Our Chairman indicated at the outset of this meeting that he would have a question and answer period following the presentation of all of the papers. This presents somewhat of a problem for me inasmuch as I am expected to be at the Ohio State Bar Association meeting in Cincinnati this afternoon at 3:00 P. M. If agreeable to the Chairman, I will be very glad to answer or attempt to discuss any question that might arise upon the conclusion of my remarks.

My address will be limited to reviewing and analyzing the accountant's present role—the role he can or should play in state administration; the reasons which have precipitated them; and the need for increased vigilance and activity on the part of the accountant if, in my opinion, he is to occupy the proper important and legitimate role of his profession in the tax field. His greatest and primary concern is in the area dealing particularly with the federal income tax. This tax burden creates the greatest impact. Most accountants are somewhat tolerant of state taxes but often unmindful of the true sphere they occupy in relation to the great number of such taxes. As an illustration, in Ohio, every day in the year, approximately five and one-half million dollars are assessed and collected for state and local government. At the same time, the federal government is collecting approximately two and one-half to three times as much from Ohio taxpayers. Despite these heavy tax burdens, the majority of taxpayers, and also accounting and other professional groups, have a keen interest and deep understanding of the importance of tax compliance and the attendant problems of tax administration.

I am sure if a survey were made of interstate industry throughout the United States, it would show Ohio's tax structure to be the fairest and most equitable, but not necessarily the least burdensome. Persons paying taxes do not offer nearly as great an objection if they feel they are paying a fair and equitable share in relation to their competitors or other taxpayers.

Public relations with taxpayers: Taxpayers look to accountants primarily for tax service in establishing effective record-keeping systems, to permit compliance with the various tax laws, and, in many instances, for the preparation of the necessary returns and accompanying schedules. Tax compliance is extremely costly on the part of the taxpayer. As President of the National Tax Association, I was recently ordered by the Executive Committee to establish a committee to study the costs of compliance at the taxpayer level as well as the administration level. The committee is now functioning and I am sure the results of this undertaking will be very startling and worthwhile.

There is often resentment on the part of accountants due to the requirements imposed in the preparation of schedules to accompany returns. For purposes of illustration, I would like to refer again to the Chairman's remarks with respect to what should be charged on the books of a company as "expense" or as "capital assets." For purposes of an income tax it is not so important whether an item is immediately charged to expense or if it is capitalized and depreciated. If the income tax rate remains constant, the results over a period of time would be approximately the same. For purposes of expediency and uniformity, the laws of many states are based upon the book value of assets as the basis for which to determine state or local taxes. It is evident that the policy followed by various companies as to what they choose to capitalize or expense can resolve in great discrepancies between taxpayers under a property tax law. As a result we have found that it is not feasible in this state to accept accounting procedures which have been established primarily for income tax purposes in computing and determining value for our property tax. We are looking for value. Under a property tax, if proper value is not obtained or received for assets as of each tax listing date, the tax is lost forever. For income tax purposes, by expensing the items you may pay less one year than the next but, as mentioned previously, over a period of time there will be no substantial income tax gain or loss. Consistency with respect to uniform procedure is important.

In the administration of a property tax, there is much virtue in establishing a yardstick to produce uniform results, even though they may appear to be arbitrary. Complaints and objections are minimized where all taxpayers or their representatives know that everyone is being assessed by the same method.

In his public relations role, the accountant is called upon to give advice and to educate his clients as to the economic impact of taxes. This relates to his client's personal tax as well as his business tax. An accountant is in position to do this because he has an insight into his client's business as well as the entire tax structure. Most tax problems can be understood, analyzed and solved in a more satisfactory manner through an accounting approach than by any other procedure. I say this with some reservation since I happen to be a lawyer, but realize full well that most tax problems are those of accounting.

The accountant acts as an intermediary between his client and the tax officials. Almost every tax form in use in Ohio has been prescribed by the tax commissioner with the assistance of the tax committees of the Ohio Society of Certified Public Accountants, the Ohio State Bar Association and representatives of taxpayers. We confer with them regularly for advice and criticism in the interest of improving tax administration. Members of the accounting group have an understanding of and are very cooperative in this undertaking. All tax forms provide a place for the name and address of the accountant who prepares such return. In the event an audit of the return discloses an overpayment or deficiency, we first call upon the accountant to explain the discrepancy. This gives him an opportunity to visit his client and advise him of the situation. We feel that this is good public relations.

You may be interested in knowing that during the period of a year, our refunds number more than our assessments. However, the amount of the refunds, as you may suspect, does not equal the amount of the increased assessments.

Too often it develops that a return is filed without the accountant disclosing his name as having prepared the return. Our only alternative is to contact the taxpayer and this often results in embarrassment to the accountant and it may provoke strained relations between the accountant and the Department. This we try to avoid. There is a definite mutuality of interest in this area and we want to cooperate to the utmost but not to the extent of minimizing the tax burden, only in attaining uniform compliance. We are not unmindful that in today's economy it would not only be parlous but impossible for tax officials and others to attempt to administer the provisions of our tax laws without the assistance and cooperation of accountants.

In many instances, we must of necessity look to the accountant for the completion of the various tax returns as well as necessary supporting schedules. This work can be voluminous, time consuming, and in some cases, objectionable. I believe I have made it clear why we must require certain data for audit and compliance purposes. We prefer to work with the accountants who can obtain the cooperation of the taxpayer and accordingly improve our relationship.

An appreciation of tax agency functions on the part of accountants is of utmost importance. I realize that tax problems are not and should not be the accountant's most important problem. Accounting serves many other purposes with which you of the accounting profession are familiar. Nevertheless, you cannot afford to underestimate an appreciation of agency functions. I am sure that here in Ohio our relations with the accounting profession is of the very best, particularly with the various CPA organizations.

Another area of great importance in public relations of the accounting profession is that of legislation. This again harks back and is pointed and critical of this profession but in accord with the statements of Mr. Inglis. While accountants participate indirectly through their asssociations in the legislative picture and accordingly do exert some influence, nevertheless it is my observation that you have been basically ineffective and not influential. To my knowledge, at the present time there are no CPA's who are members of the Ohio General Assembly. There are possibly one or two U.S. Congressmen or Senators in Washington who are CPA's. Are you too busy to be concerned with legislative matters or is the profession so lucrative that you cannot devote part of your time to this important function?

If we are to have a fair and equitable tax structure, controlled spending, and greater efficiency in government, who is in a better position to know what should be done than those who are accountants and have been successful in their profession? As a general rule, politicians tend to give the public what it wants. The high rate of spending taking place today is being asked for by the public and you know the results. Substantially all states, last year and again this year, are spending more money than they are receiving in taxes. With the exception of one other year this is the first time this has happened at the state level in 10 years. This results from the need of capital improvements in highways, schools and building programs in the welfare field. Most of the funds for these capital improvements have come from bond issues. At today's interest rates, this is a costly process. At the present time, at the recommendation of our Governor, the Ohio General Assembly is increasing taxes in an attempt to reverse this trend in order that state and local government may be more on a pay-as-you-go basis.

In the past 10 years, the state and local government taxes of practically all of the states have more than doubled. Fortunately, not until the present time has our General Assembly been required to consider any substantial increases in revenue. Thus far we have been able to finance state and local agencies by increased revenue from many of our existing excise tax sources that have responded proportionately to inflation and increased business activity. There has also been a substantial increase through the years in local property taxes which has resulted from large investments made in plant equipment and building, including homes, along with increased levies which have been voted on local duplicates.

It is estimated that by 1970 the cost of financing our public school system will have doubled. We also know we are far behind in highway construction. Then, too, there is immediate need for improving and enlarging the Ohio welfare program.

The foregoing clearly illustrates the need for increased activity on the part of your group because of the economic impact which exists at this time and which will increase in the future, not only for the individual, but also for business entities.

The lack of integrity in many of our tax laws at both the federal and state levels should be of great concern to all of us. I know that many of you have felt resentment when you have encountered a situation where one taxpayer obtains an advantage over another by reason of certain exemptions or exclusions in our tax laws. Many of these unwarranted exemptions found their way into our laws through pressure groups and for selfish reasons. In addition, many of the inequalities were caused by court decisions. In view of the extreme tax burden we all must bear, I am sure that certain judges have had more sympathy for the taxpayer than for the tax administrator. Decisions based on equity and not on law for the purpose of affording relief to a taxpayer play havoc with uniform administration. It is interesting to note that in the last five years the Ohio Supreme Court has completely reversed several administrative procedures that were established in the late twenties and early thirties and which have been in effect for nearly 30 years.

We are fortunate that under the present Ohio tax structure we have, in my opinion, a minimum of inequities in our tax laws. Inequities become more troublesome as the tax burden increases. It is plain to see that this condition merits not only continuing education and effort but increased activity on the part of accountants in the national, state and local tax fields.

Tax legislation should be and always has been geared more and more to generally accepted accounting principles and procedures. This promotes ease of compliance, better understanding on the part of the taxpayer and tax administrator, and effects a more uniform application of tax laws.

Accountants are called upon more every day to represent their clients before administrative officials. In my office as tax commissioner, I have a General Hearing Board of seven members who hear and review 5 to 6,000 tax cases annually. To state it conservatively, at least 75 per cent of the representatives appearing before the Board are accountants. The relationship between the Board and the accountants is excellent.

It is to the benefit of all and imperative that we must continue in every way possible to improve the effectiveness of tax administration through technical assistance programs with accounting groups throughout the state. This we have done in the past and I hope we will be able to continue to do in the future. Oftentimes our busy schedule makes it somewhat difficult, but we always attempt to do the very best we can. As I mentioned previously, I have always asked accountants, as well as others, for their criticisms in all areas of tax administration.

I believe we have accomplished much in the improvement of tax forms and procedures but I am not satified with the accomplishments in the area of legislation. This poses problems on the part of many accountants. While they have knowledge of certain changes that should be made in legislation, there is a feeling that same might be detrimental for certain of their clients, but I believe there is a principle which solves this predicament. If the law is bad and only benefits a few taxpayers but is detrimental to many, then the few must forego their benefits for the good of the majority.

To improve tax administration and our relations with accountants, we constantly strive to obtain the most capable and qualified personnel we can find. You can debate and argue the merits of many tax laws but I am sure that all will agree that that is best which administers best. Professional groups such as yours must have respect for public officials and, in turn, public officials must respect professional groups and representatives of taxpayers as well as the taxpayers themselves. This can only be accomplished with well-trained and capable personnel. Periodically throughout the year we contact the universities and colleges in Ohio to recruit graduates in the field of commerce who have majored in accounting. The results have been reasonably good. However, in many instances this Department acts only as a training school for new recruits since after several years with us many of them are offered positions in industry at salaries far beyond what we are able to pay. I can assure you that we have a very fine staff of outstanding personnel who are dedicated to public service.

Based on my many years in public service, I can state unequivocally that the ethics of CPA's on behalf of their clients in tax compliance is the very highest. Only once in 15 years have I found a CPA who misrepresented the facts in a particular case. The standard of ethics in the non-regulated public accounting field, while good, still needs to be improved. The complexity of our tax laws often results in noncompliance on the part of taxpayers. The inability of certain tax representatives to comprehend the provisions of our laws likewise creates many problems in compliance.

Permanent tax study committees are needed for simplifying and strengthening our tax structures at all levels of government. The membership of such committees should be comprised of accountants, lawyers, businessmen, and others. Everyone has much at stake and this is too important a matter to be further neglected.

In concluding, I would like to re-emphasize the importance of the accountant in state taxes which is ever-growing and expanding and which necessitates increased endeavor and vigilance on his part if he is to not only continue in but enlarge upon his role in state tax administration.

Again I thank you for being permitted to express my views on this subject.

DISCUSSION

FROM THE FLOOR: In the depreciation schedule set up for commutation of depreciation rates, is anything going to be done in the near future to bring that up to date?

MR. BOWERS: It is revised from time to time. I suspect when you say bringing it up to date you mean revising the annual depreciation rates.

FROM THE FLOOR: Are there current compilations of the new year?

MR. BOWERS: Yes there are. They are put out annually. We publish a personal property tax manual that is revised currently and the supplements are mailed to the holders of the manual. It can be obtained from our office. It is one of the best methods of obtaining such information. We also furnish regularly to such companies as Commerce Clearing House and Prentice-Hall, changes made by the department that will have an effect upon all taxpayers within the state. Again, all our rules are filed with the Secretary of State and your trade associations and other groups have access to them.

INTERNAL INSPECTIONS FOR BETTER TAX ADMINISTRATION

HARRY J. TRAINOR
Assistant Commissioner, Inspection, Internal Revenue Service
Washington, D. C.

The many and complex transactions in modern industry and government have required the assignment of responsibilities to officials in lower level positions. Of necessity, top-management has delegated to members of the organization an appropriate portion of its responsibilities with proportionate authority for the fulfillment of these responsibilities. The heads of organizations cannot under any circumstances delegate their over-all responsibility or any portion of their accountability.

Under these conditions, they need management controls to a much greater extent than under the smaller and less complicated type of organization. The development from the small organization to today's elaborate structure has accentuated communication problems between the policy levels and the operating levels of management. Successful management must devise a means to appraise and evaluate the results of its planning and policy making.

Decentralization of authority to carry on functions creates a much greater responsibility for the middle management executives located in field offices and locations, and subsidiary corporations. These executives are required to solve many complicated operating problems within broad guidelines of general policies and procedures.

In a decentralized organization, operating people sometimes believe that their work should not be reviewed and that their actions and decisions are final. Decentralization should mean more control because limits are usually placed on employees and their work is periodically reviewed. Field employees should not be left to work by themselves and personal contact with the higher levels must be maintained.

Management control is obtained largely by maintaining at all times proper communication between the various management and operating levels. Management officials must have a free and constant flow of information in order to appraise properly the operations. Modern management may largely accomplish this by providing for certain "play-back" features built in the organizational structure. These may consist of functional and line supervisors and their staffs of visiting and reporting analysts. But of most importance, all levels of management should be assisted by an able and independent internal auditing staff operating under a system that will require all management officials to take appropriate corrective action whenever it is required.

Successful management also must be sure that its employees possess the highest degree of integrity and are completely honest and ethical in handling official transactions. Management needs, also, assurance that the personal lives of its employees will not result in embarrassment or disgrace to the whole organization. It is necessary that prospective employees be carefully investigated and screened and that a program of security be observed during their employment.

The Internal Revenue Service is, of course, the biggest operation of its kind in the world. We are an $80-billion a year business in total tax collections, accounted for by more than 97 million tax returns and supported by some 250 million other items, such as information documents, and so on. We have some 50,000 employees to handle this workload and to provide the necessary enforcement activities.

It can readily be understood that employees who are engaged in the Revenue Service type of activities are frequently subjected to temptation. Our employees are in the position of making decisions that substantially affect the finances of taxpayers; their decisions may result in prosecution of taxpayers; and they collect and handle large sums of money in transactions and situations that, by their nature, are subject to only minimum controls.

On the other hand, employees must be cleared of unwarranted or erroneous charges and allegations. Good management requires that employees be advised when investigations result in clearance, and the files of employees should record clearly the results of investigations of charges and allegations.

The Internal Revenue Service has provided a means for control by top-management whereby operating information is made available to all levels of management, and communication between the levels flows more freely. The Revenue Service also has devised a system to determine the integrity of its employees. The Inspection Service was set up to assist all management officials in solving these problems.

INSPECTION SERVICE

The Office of the Assistant Commissioner (Inspection) is relatively new to the Internal Revenue Service and because its activities are confined primarily to the internal affairs of the Service, its functions and activities are not generally known to the public or to tax practitioners. The present organization is an outgrowth of several reorganizations that started in the early 1950's.

As originally constituted, Inspection lacked independence and its responsibilities overlapped those of the operating activities. The present organization is truly a fact-finding body with no authority or responsibility for activities of employees of the operating functions. It has a realistic internal audit and investigative program of broad scope with the necessary independency and the ability and means of effecting corrective action by the operating entities.

The Inspection organization consists of a national office and nine regional offices located in the same cities and serving the same geographical areas as the Regional Commissioners of Internal Revenue. The Inspection organization at both the national and regional levels is divided functionally into two divisions: Internal Audit Division and Internal Security Division. It is a line organization, entirely independent of all other Revenue Service organizations. The nine Regional Inspection Offices are headed by Regional Inspectors who are directly responsible to the Assistant Commissioner (Inspection) who, in turn, is directly responsible to the Commissioner of Internal Revenue.

Internal Audit

Internal Audit in the Government is a legal requirement imposed by Section 113 of the Budget and Accounting Procedures Act of 1950 which directs the head of each executive agency to establish and maintain systems of internal control designed to provide, among other specified things, "Appropriate Internal Audit."

The Commissioner of Internal Revenue has directed that the Internal Revenue Service's Internal Audit activities include the independent review and appraisal of all Revenue Service operations as well as the analysis and verification of financial activities. The Commissioner has also directed that the Internal Audit function be a completely integrated part of the management control system of the Internal Revenue Service and that the information contained in Internal Audit reports be fully utilized.

The primary purpose of the Internal Audit function is to assist all levels of management in achieving the most efficient administration of the Internal Revenue Service. This is accomplished by identifying and reporting on problem areas and deficiencies in procedures or practices and, wherever possible, suggesting practical solutions.

While national and regional officials of the Internal Revenue Service have been delegated extensive authority in their respective areas, the Commissioner is primarily responsible for the efficiency and effectiveness with which all Revenue Service activities are performed. He, therefore, looks to Internal Audit to give him a factual and candid appraisal of the manner in which the various organizations are carrying out their assigned functions. In this way he is able to obtain a picture entirely independent of that afforded by direct organizational reporting. Similarly, all levels of management, under the Commissioner, are provided with an independent appraisal of the manner in which the organizations under their jurisdiction are conducting their respective activities.

The general objective of the Internal Audit program is to provide management with a protective and constructive service through an independent review and appraisal of the accounting, financial, and other operating activities of the Internal Revenue Service. Specifically, the basic objectives are to determine that:

(a) All functions are being conducted efficiently and effectively and in accordance with law and Revenue Service policy, and that they continue to serve their intended purpose;

(b) Expenditures are made only in the furtherance of authorized activities, and comply with applicable laws and regulations;

(c) All revenue and receipts from Revenue Service activities are collected and properly accounted for;

(d) All assets of the Revenue Service or in its custody are adequately safeguarded, controlled, and utilized effectively; and

(e) Both internal and external reports are accurate, meaningful, and useful.

Operating officials of the Internal Revenue Service are responsible for taking full corrective action on deficiencies disclosed by internal audits. To be effective, the Internal Audit function must be properly implemented by prompt and effective corrective action by the top local official of the office audited. This requires a thorough understanding of the Internal Audit function and its objectives, as well as complete cooperation on the part of operating officials. Internal Audit has neither the responsibility nor the authority for taking corrective action.

The District Director in the Internal Revenue Service is responsible for taking corrective action on Internal Audit findings when a District Office is audited, and the Regional Commissioner is responsible for seeing that corrective action is taken by the District Director. This is controlled by reports prepared by the various levels of management on up to the Commissioner.

The review of closed tax cases has been the subject of much discussion and I might say it is one of our activities that has been subject to considerable misunderstanding. Therefore, I want to emphasize at the start that Inspection does not reopen tax cases and has no authority to order the reopening of a tax case. The responsibility for making a decision as to whether a tax case should be reopened is that of operating officials, and Inspection does not transgress on this responsibility or in any way influence the official who makes the decision.

Actually, we spend only a small percentage of our total Internal Audit examination time on the review of cases. During the course of an internal audit, the internal auditors look over a small sample of closed tax case files so management officials can have some assurance that revenue agents are following prescribed procedures in making tax audits, and that the District Office Review staffs and the analysts under the Regional Commissioner are properly performing their respective post review functions. The internal auditors are limited by instruction to determine if prescribed policies and procedures are followed and not to superimpose their judgment as to technical determinations on that of technical personnel.

By demonstration and education, we are proving to the various managers in the Revenue Service that the work of Internal Audit is done for their benefit, and that it is their right arm sorting out for them those points that need their administrative action.

The value of internal audit in any organization depends, to a large degree, on the extent of support given by top-management officials. It is appropriate to quote the following excerpt from the "Statement of the Responsibilities of the Internal Auditor" approved by the Board of Directors of the Institute of Internal Auditors, Inc.:

> ". . . The organizational status of the internal auditor and the support accorded to him by management are major determinants of the range and value of the services which management will obtain from the internal auditing function."

In the Revenue Service we are fortunate in that we are properly located in the organization and we have had the complete understanding and backing of top Treasury and Internal Revenue officials.

Internal Security

The integrity of the Service is protected by character and conduct investigations made by the Internal Security Division of the Inspection Service.

The basic purpose of conducting a character investigation of an applicant or employee is to secure sufficient evidence to establish the individual's suitability for employment or retention in employment in the Internal Revenue Service. These investigations also serve as one of the basic tools of management in its continuing process of selecting individuals suitable for appointment and promotion. Character, reputation, and loyalty to the United States are the important elements considered. The facts and information obtained during the course of the investigation are assembled in a report which is used as the basis for action by management officials who have the responsibility for appointment, or retention in employment.

Executive Order No. 10540, as amended, "Security Requirements for Government Employment," requires that appointment of each civilian officer or employee shall be made subject to investigation. The scope of the investigation is determined by the nature of the position. The interests of good management and national security require that all persons privileged to be employed in the government shall be reliable, trustworthy, of good conduct and character, and of complete and unswerving loyalty to the United States.

The purpose in conducting investigations of complaints and allegations against employees of the Internal Revenue Service is to determine all pertinent facts and report them to management officials who decide if the employee is suitable for retention in the Revenue Service, and for necessary action to separate or otherwise discipline, or clear the employee as the case may be.

When anyone makes a charge or allegation it is mandatory that a full inquiry be made of all of the facts and circumstances so that management can take proper disciplinary action or clear the employee of the charges where appropriate. It is interesting to note that of over 2,000 conduct-type investigations made last year, 719 disciplinary actions resulted. We are proud that our work resulted in clearance of hundreds of the other employees investigated. Our employees are becoming increasingly aware of the protection that Inspection gives them against unwarranted or erroneous charges and allegations, as evidenced by a statement made by an officer of the National Association of Internal Revenue Employees, an employee organization to which nearly half of our Revenue employees belong.

This officer stated: "I am certain that I represent the vast majority of our members when I say that we are indebted to the Inspection Service for the protection it affords our job rights and the integrity of the Revenue Service. It is a bulwark of security for which we feel justly proud."

Frequently, during a conduct investigation it is necessary or desirable to make tax audits or fraud investigations. For example, we may have information that an employee of the Revenue Service has received a substantial payment or gift of some sort from a taxpayer who has been audited by the employee. In order to be sure that the audit has been properly made, it would be necessary to review the audit and possibly to reopen the examination. In such cases, the audit work is done by employees of the Audit Division, or Intelligence Division when fraud is indicated. Inspection requests such examinations of the appropriate Regional Commissioner and is furnished a copy of the report for inclusion in the Inspection investigative report. Inspection makes no determinations of its own in such tax reexaminations.

Inspection has many important relationships with other Government activities. The more important ones are described below.

Each Regional Inspector is required to refer to the appropriate United States Attorney those cases where investigation has indicated that a Federal law may have been violated. A full factual investigative report is handed the Department of Justice official and he decides if prosecution will be made.

The Federal Bureau of Investigation has primary responsibility for the investigation of matters involving: theft of Government property, suspected subversive activities, capital offenses committed on Government property, civil rights violations, and impersonation of Federal officers.

On July 1, 1955, a procedure was established to carry out effectively the joint investigative responsibilities of the F.B.I. and Inspection for enforcing properly the criminal provisions of Title 18, U.S. Code, when Internal Revenue Service employees are involved. The F.B.I. has rendered a great service to the American public in cooperating with the Revenue Service toward maintaining a high degree of integrity.

When an investigation of this type is made by the F.B.I., and circumstances require, Inspection assists by reviewing the accounts or workload of the employee involved and does any other work requiring access to Internal Revenue files and records. Certain types of investigations have been excluded from the procedure and are made entirely by Inspection.

The Civil Service Commission has primary investigative responsibility in Hatch Act violations. As you know, these are cases where employees engage in political activities contrary to the Act. Where necessary, Inspection makes a preliminary investigation sufficient to determine whether there is substance to the allegations to warrant referral to the Civil Service Commission. If the Civil Service Commission decides to conduct further investigation, Inspection, upon request, cooperates with the Civil Service Commission in making a joint investigation.

Any investigation involving misuse of the mails comes under the jurisdiction of the Postal Inspectors. Many of these matters are worked jointly and we have a splendid relationship with this capable organization.

Inspection works closely with the Intelligence Division of the Revenue Service. Summarily, we can describe the Intelligence function as all those Internal Revenue activities designed to reveal taxpayers' fraud, collusion, or criminal intent to avoid tax payment. We can draw a distinction between the Intelligence and Inspection functions by saying that Intelligence activities are focused on taxpayers while the Inspection activities are focused on employees of the Revenue Service.

Information on taxpayer investigations which may involve employee misconduct may come from Intelligence, the taxpayer, or other sources. Inspection investigates employee conduct in such a manner as not to prejudice the prosecution of the taxpayer's case. The coordinated handling of this type of investigation is highly important. Some of these investigations have to be handled jointly by Intelligence and Inspection. A recent joint investigation involved a charge by an attorney that a Revenue Service employee had solicited a bribe; the employee, in turn, accused the taxpayer of trying to bribe him.

Sometimes, dishonest taxpayers may initiate what we call "smoke screen" cases. Close coordination between the two functions must be maintained in handling such situations because the credibility of the special agent of Intelligence making the tax fraud investigation might be impaired if the taxpayer's counsel could point out that the special agent was being investigated by Inspection for misconduct.

We believe that the present arrangement, whereby allegations against special agents are investigated by Inspection, an entity independent of operations, is sound. Otherwise, a taxpayer might feel that his allegations had not been fairly investigated in an objective and independent manner.

Joint Supervision

The joint supervision of Internal Audit and Internal Security at the national level under the Assistant Commissioner permits a close day-to-day relationship and enables the necessary coordination of the activities of the two Inspection functions.

Investigations of employee misconduct by Internal Security sometime disclose procedural weaknesses requiring the attention of internal auditors who have the responsibility and "know-how" to appraise internal controls. This happens frequently in embezzlement cases. Recent embezzlement investigations revealed that the employees involved were manipulating receipts from various taxpayers to conceal embezzlement. In other cases, the Internal Security investigations revealed that taxpayers' money orders were being signed and cashed by Internal Revenue employees. The internal auditors studied the procedures and found them deficient and so reported to operating officials who took action to revise the forms and procedures, thus minimizing the probability of recurrence.

Certain employee conduct investigations require the skills of both investigators and internal auditors. Embezzlement cases always require a circularization of all accounts receivable assigned to or handled by the suspected embezzler as well as a review of all of his accounts written off as uncollectible. Confirmations of receivables and account checking are the work of auditors and, of course, investigative work is required to establish the facts and evidence of the embezzlement. It has been necessary to assign both internal auditors and investigators to cases involving not only allegations of misconduct but also mismanagement, negligence, failure to supervise and failure to maintain proper accounts. Investigations of this type require familiarity with operating procedures and knowledge of auditing techniques, as well as knowledge of investigative techniques.

On the other hand, the internal audits of the operating divisions frequently indicate employee misconduct that requires investigation. For example, in a number of instances the work of the internal auditors disclosed payments that had been made by taxpayers which were not properly deposited and credited to the accounts.

* * * * * *

The present organization conforms to the original concept of Inspection as indicated by the former President of the United States when he explained the reorganization of the Internal Revenue Service:

> "A strong, vigorous Inspection Service will be established and will be made completely independent of the rest of the Bureau. Through a comprehensive system of audits and inspections, this Service will keep operations and management of the Bureau under continual

> scrutiny and appraisal. It will have the responsibility coupled with full authority of detecting and investigating any irregularities. . . . In view of its importance, the nation-wide direction of the Inspection Service will be the sole responsibility of one of the three Assistant Commissioners of Internal Revenue."

* * * * * *

We believe that the establishment of the Inspection Service and its acceptance and use by management officials is evidence of the many forward steps taken by Treasury and the Internal Revenue Service for improved tax administration.

RULINGS AND FEDERAL TAXES

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Introduction

Early certainty of the tax consequences of business transactions is generally desirable. Foreknowledge of the Treasury Department's views of the tax impact resulting from the adoption of a particular form in which a transaction is proposed to be consummated may be helpful in minimizing the tax since it may permit the timely adoption of a more economical form for the transaction. Hence, an appreciation of the value of timely official rulings and an understanding of the conditions under which they may be obtained and how to proceed should be of value to everyone concerned.

Taxpayers and practitioners alike are often amazed to find that the advance ruling procedure, which is so important in tax planning, is almost completely without statutory basis or authority. Admittedly, it is somewhat surprising to find that such an important Internal Revenue Service function, utilizing approximately 427 employees in the Service's National Office and producing some 43,000 rulings per year, does not have a clear statutory basis.

While it has always been possible for field representatives of the Service to get advice from the National Office on a more or less informal basis, it was not until about 1940 that the Commissioner instituted the practice of advising taxpayers of the probable tax effect of prospective transactions. The earliest rulings were in the area of corporation reorganizations and dividends, soon to be followed by pension trust rulings under the 1942 Act.

Basis for Rulings

Some authority for the ruling procedure can be found in the Code provision which grants the Commissioner discretion to determine the extent to which rulings or regulations shall be applied without retroactive effect.[1] Other authority for the procedure can be found in the various sections providing for certain tax consequences only if the Commissioner determines, in advance, that tax avoidance is not one of the principal purposes of the transaction.[2] Similarly, many sections of the Code require taxpayers to

* The author gratefully acknowledges the assistance of W. T. Barnes and C. W. Stowe, Lybrand, Ross Bros. & Montgomery, Washington, D. C. in the preparation of this article.

[1] 1954 IRC, Sec. 7805(b).

[2] 1954 IRC, Sec. 367; 1954 IRC, Sec. 1491, 1492.

treat certain items consistently from year to year unless they obtain the Commissioner's permission to change.[3]

Nature and Purpose of Rulings

Commissioners of Internal Revenue have wisely recognized that some of the disadvantages and annoyances of our burdensome tax structure will be ameliorated if taxpayers are able to obtain an advance determination of the tax effects of major transactions as soon as possible. It is therefore the policy of the Service to answer inquiries as to the tax effects of prospective transactions whenever it is appropriate and possible in the interest of sound tax administration.[4] So far as taxpayers are concerned, a favorable ruling, if it can be obtained, takes the gamble out of the transaction and simplifies problems of review with the revenue agent. Even an unfavorable ruling may permit the revamping of the proposed transaction so as to meet the Service's objections, or at the worst, removes the element of surprise when a deficiency is finally proposed.

In spite of the advantages and benefits to be gained from tax rulings, it seems clear that there are circumstances under which taxpayers are well advised not to request rulings. For example, if a proposed transaction can be carried out in only one manner, it may not be desirable to seek an advance ruling. Under these circumstances about the only advantage to be gained is the ability to discuss the matter with the highly qualified personnel of the National Office. Because so many National Office employees are specialists, it is sometimes beneficial to be able to discuss the tax effects of a transaction with them. Even though an advance ruling is not obtained, however, discussions with National Office personnel can ordinarily be secured through the medium of technical advice.

Similarly, it is ordinarily not wise to seek a ruling upon a completed transaction. When a transaction has been completed, the applicable facts which will ultimately determine the tax effect have been established and ordinarily nothing more can be done to alter the tax liability arising therefrom. Under these circumstances, the taxpayer runs a real risk of obtaining an unfavorable ruling from the National Office and restricting considerably the possibilities of administrative review and discussion at Service levels below the National Office. While the decentralization of the Service (which has taken place during recent years) has vested the responsibility for making decisions as to tax liabilities in the hands of District Directors, it is clear from a practical viewpoint that rare indeed is the Revenue Agent, Group

[3] eg. 1954 IRC, Sections 167, 442, 446.

[4] Statement of Procedural Rules, Sec. 601.201, C.B. 1955-2, 944.

Chief, or Appellate Division Conferee who can be persuaded by a taxpayer's arguments when the National Office has already ruled against the taxpayer's position.

A ruling is ordinarily defined as a "written statement issued by the National Office of the Internal Revenue Service which is an expression of the official interpretation or policy of the office of the Commissioner of Internal Revenue."[5] A "determination letter" is a written statement by a District Director which applies principles and policies previously established by the National Office to the specific facts involved in a particular case.[6]

How Rulings Are Issued

The determination of principles and policies involved in the rulings procedure and the actual issuance of rulings are responsibilities of the Assistant Commissioner of Internal Revenue (Technical). His office must develop principles and policies with respect to the rulings procedure, coordinate rulings involving novel or disputed questions with the office of the Chief Counsel of the Service, provide technical service in drafting proposed legislation, prepare regulations, return forms and instructions, and issue *Internal Revenue Bulletins* and various technical manuals. Each of these functions has an effect upon the rulings program.

The immediate responsibility for the rulings program is vested in the Tax Rulings Division of the National Office. There are eight branches in this division, as follows:

1. Individual Income Tax
2. Corporation Tax
3. Reorganization and Dividend
4. Estate and Gift Tax
5. Excise Tax
6. Employment Tax
7. Pension Trust
8. Exempt Organizations

The Individual Income Tax Branch also handles estates, partnerships and trusts other than employees' trusts and exempt organizations. The Excise Tax Branch handles all excise tax matters except alcohol, tobacco, narcotics and firearms taxes which are the responsibility of the Assistant Commissioner (Operations). The Reorganization and Dividend Branch

[5] Statement of Procedural Rules, Sec. 601.201, *supra.*

[6] Statement of Procedural Rules, Sec. 601.201, *supra.*

is responsible for rulings upon all questions arising under Subchapter C of the Code except those involving sections 381 and 382. The latter are the responsibility of the Corporation Tax Branch.[7]

When No Ruling Will Be Issued

We have seen that, with a few exceptions, there is no specific statutory authority which requires the issuance of rulings. It follows, then, that the issuance of rulings is a matter of discretion of the Commissioner, and as one would expect, there are many situations in which he will refuse to rule.

No advance ruling will ordinarily be issued in a hypothetical case. For example, until a decedent passes away, questions involving the estate tax liability under his will are ordinarily deemed to be hypothetical since the decedent may decide to change his will any number of times prior to his death. For this reason, it is extremely difficult to obtain an estate tax ruling until the decedent has passed away, and unfortunately, after his death the possibility of an unfavorable National Office attitude frequently makes it undesirable to request a ruling. The Commissioner ordinarily refuses to rule upon those matters which he deems to involve primarily questions of fact.[8] Question of whether a corporation has unreasonably accumulated its surplus (section 531), the reasonableness of officers' salaries, the market value of property, whether *inter vivos* transfers were made in contemplation of death, and whether or not transfers or acquisitions run afoul of sections 269 or 1551 because the principal purpose was avoidance or evasion of Federal income taxes are all examples of matters upon which the Commissioner will not rule in advance of examination of the returns involved. Oddly enough, this very question of whether tax avoidance was a principal purpose forms the basis of some of the sections of the Code which specifically require the Commissioner's advance ruling.

Since the issuance of a ruling is for the most part a matter entirely within the discretion of the Commissioner, it is not unexpected to find that there are many areas in which he refuses to rule simply as a matter of policy. For example, there sometimes occur situations in which it is quite clear that a transaction will produce a certain tax effect but the Commissioner is unwilling to agree that Congress intended this result. Under these circumstances, it is common for the Commissioner's office to take the position that the taxpayer is correct in his analysis of the problem but the Commissioner nontheless refuses "to issue an insurance policy in advance"

[7] Commissioner's Statement on Organization and Functions filed in the Federal Register, December 27, 1956.

[8] Statement of Procedural Rules, Sec. 601.201, *supra*.

to the taxpayer. For example, the Commissioner will not ordinarily rule that a redemption of stock is not essentially equivalent to a dividend under section 302 (b) (1) in any case where the attribution of ownership rules under section 318 would prevent the redemption from being a termination of interest or a disproportionate redemption under sections 302 (b) (2) and (3). Similarly, the Service will not ordinarily rule upon the liquidation of a corporation under sections 331, 333, or 337 where part of the assets were involved in a reincorporation immediately before or after the liquidation.

The Commissioner will not issue a ruling when a Court has recently decided the point at issue, and no decision has been made as to whether an appeal will be taken or where there are conflicting court decisions upon the issue.

How to Request a Ruling

Rulings must be requested in writing, addressed to the Commissioner of Internal Revenue, Washington 25, D. C., and if known, for the attention of the appropriate branch of the Rulings Division. The application must contain a complete statement of relevant facts including names and addresses of all interested parties together with a copy of each contract, agreement, will, trust instrument, or other document necessary to present a full and fair statement of important facts. The application should contain a complete and precise statement of the business reasons for entering into the transaction. If a corporate reorganization or distribution is involved, a copy of the latest balance sheet of each of the corporations involved should be attached.[9] These statements need not be certified by independent auditors and need not be completely up to date. They will probably be accepted if they are as much as 6 to 8 months old, provided a statement is included to the effect that there have been no material changes therein other than those brought about by the ordinary operations of the business.

The ruling application should contain a concise statement of the taxpayer's position as to the tax effects of the transaction, an explanation of his grounds therefor, and a citation of relevant authorities. While the Commissioner's rules[10] speak of a memorandum of authorities as though it were required to be included in a separate document, the citation of appropriate authorities in the ruling request itself is ordinarily sufficient.

The request must be signed by the taxpayer or his duly authorized representative and in the latter case should be accompanied by a properly

[9] Statement of Procedural Rules, Sec. 601.201, *supra*.

[10] Statement of Procedural Rules, Sec. 601.201, *supra*.

executed power of attorney. If the taxpayer desires a conference, it should be requested in the ruling application itself or very soon thereafter.[11] Generally, only one conference is available.

The Service is quite strict in its effort to process ruling applications in the order in which they are received. Very good business reasons must be presented in order to persuade the Service to process a request out of its chronological order. It may be interesting to note, incidentally, that there is frequently a big difference between the taxpayer's and the Service's idea as to what constitutes a good business reason. For example, stockholders who are considering a merger with another corporation cannot condition their approval upon the receipt of a favorable ruling some 60 days hence and expect the Service to have much sympathy with this taxpayer-created deadline.

Generally speaking, the time required to obtain a favorable ruling varies directly with the seasonal workload of the taxpayer and practitioners. For example, in late spring or summer rulings can usually be expected in from 4 to 6 weeks from the date of filing the application. In fall and winter, many taxpayers submit ruling requests which require answers by December 31, or by the time of filing individual returns on April 15. Under the latter circumstances, unless the taxpayer can present excellent business reasons for his case being considered out of order, the ruling may require 8 to 14 weeks to issue. If under circumstances described hereafter the Rulings Division feels it necessary to obtain the concurrence of the Chief Counsel of the Service before issuing a ruling, the foregoing time table is completely inappropriate. If a ruling is coordinated with the Chief Counsel before issuance, it is ordinarily safe to add 6 to 9 weeks to the time described above.

How a Ruling Request Is Processed

In most routine cases, the appropriate branch chief has the initial responsibility for issuing rulings. He is authorized to issue rulings himself in routine cases but not where a novel question is involved, where the ruling involves the jurisdiction of more than one branch, or where a controversial legal or policy question is involved.

If a transaction involves the jurisdiction of more than one branch, and if the questions involved are independent, many practitioners follow the practice of submitting separate ruling requests. Thus, if the Corporation Tax Branch and the Individual Tax Branch are both involved with a single ruling request, one will prepare its reply and then submit it to the other

[11] Statement of Procedural Rules, Sec. 601.201, *supra*.

for consideration of the other's question. Since each requires an absolute minimum of 3 or 4 weeks under optimum circumstances an aggregate of 6 or 8 weeks is involved. If separate requests are filed, the two branches could work concurrently and much time could be saved. The foregoing practice is naturally not appropriate if the answer to either of the questions is dependent upon the other.

Cases which involve new legal questions, a conflict of legal precedents, legal authority for new administrative policy, or which are likely to result in litigation, are coordinated with the office of the Chief Counsel of the Service before the ruling is issued by the Rulings Division. Only a small percentage of rulings is so referred. A referral of this type is not a matter of right to the taxpayer but if a case is so referred, the taxpayer is ordinarily granted a conference with the Interpretative Division of the Chief Counsel's Office. The Chief Counsel's opinion is advisory only, although most rulings which have been referred to his office ordinarily reflect a coalescing of views of the Chief Counsel and the Rulings Division.

Rulings are sometimes submitted to the Counsel himself or to an assistant Counsel for a thorough policy review where they tend to encourage or discourage certain types of business or tax avoidance transactions, involve acceptable alternatives and large numbers of taxpayers are concerned, involve administrative complications although legally sound, involve the question of further litigation or an attempt to obtain corrective legislation, or involve the nonretroactivity of rulings.

As a matter of policy, before issuing a ruling the Rulings Division may consult other divisions of the National Office, such as the Technical Planning Division is concerned with regulations, legislation and forms, the Special Technical Services Division with engineering and valuation matters, and the International Tax Relations Division with tax treaties and other aspects of foreign taxes.[12]

Rulings are rarely referred to the office of the Secretary of the Treasury prior to their issuance. Authority to grant them has been formally delegated to the Commissioner.[13] There are some exceptions where as a matter of policy the Secretary's office wishes to be advised before rulings are issued, and, indeed, there are some indications that the treasury sometimes prevents the Commissioner from issuing a ruling. This type of case is rare, however, and ordinarily arises only where a very substantial loss of tax revenues is involved. The example, apparently this policy has been

[12] Commissioner's Statement, *supra*.

[13] Treasury Department Order No. 150-32, November 19, 1953.

followed in the case of percentage depletion on end product items pending the outcome of the Treasury's effort to obtain remedial legislation for what it considers to be an unfair and unintended tax benefit.

Withdrawal of Ruling Requests

Taxpayers are permitted to withdraw ruling applications at any time prior to the actual signing of the Commisioner's reply.[14] Many taxpayers and practitioners follow the practice of reserving in the ruling application itself the right to withdraw the application if adverse action is imminent. Although such requests are usually honored by the Commissioner, he has made it clear that withdrawal by the taxpayer will not prevent the National Office from notifying the appropriate District Director of the National Office views upon the facts involved. In actual practice, however, the National Office rarely takes such action unless it has reason to believe that the transaction has already been consummated or will be in essentially the same form in which it has been considered by the National Office.

The Publication of Rulings

During recent years, the Service has published many more rulings than it formerly did. This increased publication arose from Congressional complaints in 1952 that the issuance of so-called private rulings (synonymous with unpublished) permitted favoritism and allowed the use of influence.[15] The effect of this criticism can be seen in the increasing number of rulings which have been published in Internal Revenue Bulletins. From only 95 items ordinary classified as rulings published in 1952 the number increased to 274 in 1953, 613 in 1954, 760 in 1955, 700 in 1956, and approximately 615 in 1957 and 1958.

The Service is quite careful to avoid disclosing the name of the taxpayer involved in a published ruling and to withhold details of the transaction which are not relevant to the tax principle involved but which might reveal confidential aspects of the taxpayer's business.

The Effect of Rulings

Each ruling contains a paragraph advising taxpayers to attach a copy thereof to the appropriate tax return. District Directors are instructed to ascertain that accurate representations of fact were made in the ruling application and that the transaction was carried out substantially as it was presented to the Service. If both of these requisites are present it is very

[14] Statement of Procedural Rules, Sec. 601.201, *supra.*

[15] House Report No. 1749, 82nd Congress, 2nd Sess.

rare for a Revenue Agent to refuse to follow the ruling. Indeed, if a District Director's office proposes to reach a conclusion contrary to a ruling, he must present his position to the National Office for reconsideration. If the facts were completely and accurately set forth in the original application, however, and if the taxpayer's position was adequately argued before the National Office it is very infrequent that a ruling will be reconsidered in the National Office at the request of a District Director.

Rulings which are deemed to be of general interest and applicability are published in the *Internal Revenue Bulletins*. The Service has indicated that taxpayers may rely upon these published rulings to determine the tax liability in their cases in substantially the same facts and circumstances.[16]

Modification or revocation can be accomplished either by notice to the particular taxpayer who obtained the ruling or by publication of a contrary ruling in the *Internal Revenue Bulletin*. As to the particular taxpayer who received the ruling, the Service policy is to apply the revocation only prospectively so long as (1) there was no misstatement or material omission of fact, (2) the actual transaction was carried out as described in the ruling request, (3) there has been no change in the law, and (4) the taxpayer relied in good faith upon the ruling and retroactive application would be to his detriment.[17] While taxpayers are permitted to rely upon published rulings in similar facts and circumstances they have no assurance that the same ruling will be in effect when their transaction is reviewed two or three years later. It is the general practice of the Service, however, to make the revocation or modification of a published ruling only prospective as to a taxpayer who has relied on the earlier published ruling.

Letters of Determination by District Directors

As defined earlier, a determination letter is an application by a District Director of principles and policies (previously established by the National Office) to a taxpayer's specific fact situation. The Director's authority to issue determination letters is discretionary and will be exercised "only to the extent consistent with a wise administration of the revenue system." He may issue determination letters only in the case of completed transactions and only when the principle involved is clearly set forth in the statute, Treasury Decision, regulations, revenue ruling, opinion or Service-published court decisions.[18]

The restriction upon the District Director's authority as to completed

[16] Statement of Procedural Rules, Sec. 601.201, *supra*.
[17] Rev. Rul. 54-146, CB 1954-1, p. 88.
[18] Statement of Procedural Rules, Sec. 601.201, *supra*.

transactions is not applicable to pension and profit sharing qualification, certain exemption applications or to employment and excise tax matters. Even with respect to the qualification for exemption of pension and profit sharing trusts, however, his authority is limited in questions involving prohibited transactions under section 503 or unrelated business income under section 511. Similarly, in the area of exempt scientific, educational, religious and charitable organizations the District Director's authority is restricted if the question involves feeder organizations (section 502), prohibited transactions (503), denial of exemption because of unreasonable accumulation (504), or unrelated business income (511).[19]

Appeal Available on Pension and Profit Sharing Determination Letters

Unlike most other cases of determination letters, specific provision has been made for a taxpayer to appeal, as a matter of right, an unfavorable District Director's decision in pension and profit sharing matters.[20] The taxpayer's right, however is not unrestricted. He must show that the proposed holding is contrary to law, regulations, published ruling, or a decision acquiesced in by the Commissioner, is in conflict with a determination on similar facts in another District or involves novel or unique facts. Even with this showing, the National Office retains discretion as to whether the matter will be reviewed in Washington.

Requests for Technical Advice

An additional procedure which enables a taxpayer to get National Office consideration of his case is known as a request for technical advice. This device, first announced in 1948,[21] ordinarily is initiated by the Service's field representative involved with the audit of a tax return. However, subject to certain limitations, the taxpayer or his representative now may initiate the action.[22]

While the technical advice means of coordinating National Offices policies and field units action was important prior to the 1952 reorganization, it became much more important with the widespread decentralization which resulted from the reorganization. This is true not alone with respect to the audit of returns but also as to determination letters issued by District Directors.

It is important to note that the term is "technical advice," and "advice" it is. The responsibility for determining tax liability remains in

[19] Rev. Proc. 56-8, CB 1956-1, p. 1024.
[20] Rev. Proc. 56-12, CB 1956-1, 1029.
[21] Mim. 6293, CB 1948-2, 59.
[22] Rev. Proc. 58-14, IRB 1958-38, 48.

the District Director and he need not follow the advice if he does not agree. There seem to be very few cases, however, where he fails to follow the National Office opinion.

Even more important to taxpayers, though, is the fact that whether the advice of the National Office is to be sought is also completely discretionary with the District Director. The taxpayer has no absolute right to have his case considered in the National Office once his return has been filed. Unfortunately there seem to be numerous cases in which Districts take the position that theirs is the responsibility and that they need no help from anyone.

It is to be hoped that such cases will be minimized by the Service policy which centralizes in the Chief of the District's Audit Division the responsibility for deciding whether the National Office will be consulted.[23] The National Office is also requiring reports from the Districts as to the number and type of cases in which a taxpayer's request for technical advice is denied.

If the taxpayer's request for National Office consideration is granted, he should file a memorandum of his position with the District Director so that it can accompany the file or be incorporated in the Director's request. A taxpayer is entitled, upon request, to a hearing in Washington if the National Office proposes to adopt a position contrary to that of the taxpayer.

The Appellate Division is also authorized to request technical advice in cases over which it has jurisdiction. Many fewer cases are submitted to the National Office via this route, however, and conferences are ordinarily not granted.

Closing Agreements

Closing agreements unlike rulings, determination letters and requests for technical advice are specifically covered by the statute.[24] Whether the Commissioner and the taxpayer will enter into the formal contract known as a "closing agreement" is nonetheless discretionary with the Commissioner.

As applied to prospective transactions, the processing of a closing agreement is very similar to that of a ruling. Up to certain levels requests for ruling and requests for a closing agreement follow the same course. Since, however, the closing agreement is a formal agreement, final except for fraud, malfeasance or misrepresentation of a material fact, it must be

[23] Rev. Proc. 58-14, IRB 1958-38, 48.

[24] 1954 IRC Sec. 7121.

reviewed by many more people and consequently requires more time to obtain. All closing agreements are referred to the Chief Counsel before their execution by the Commissioner.

Closing agreements may apply either to a specific transaction or to the tax liability for an entire year. In the latter event, all facets of the case are subject to very close scrutiny. Particularly if a taxpayer seeks the latter type of closing agreement, he can expect that issues completely unrelated to the one requiring the agreement will receive a thorough review and analysis.

SIXTH SESSION

FRIDAY, MAY 22, 12:30 P. M.
The Ohio Union—East Ballroom

Presiding:

E. W. WESTON, *Vice President, Controllers Institute of America; Secretary-Treasurer, The Weston Paper and Manufacturing Company, Dayton*

Presentation of Hermann C. Miller Memorial Scholarship

GORDON S. BATTELLE, *President, The Ohio Society of CPAs, making the presentation to:*

HARRY C. LYLE

Paper: "Business Conditions and Monetary Policy"

JOHN BALLES, *Assistant Vice President, Federal Reserve Bank of Cleveland, Cleveland*

SIXTH SESSION

Mr. Gordon S. Battelle: Mr. Chairman, ladies and gentlemen: I think some of us have been coming to this Institute for these 21 years, and I am sure that in the recent sessions we have greatly missed the warm and cordial welcoming hand of Professor Miller, who was always out among the crowd, greeting old friends, making us feel at home, overseeing all the arrangements, and making sure that the Institute was a success.

He and Jake Taylor, as you know, were close friends and associates in starting the Institute, and it was their arduous effort all during this period that has brought it to such a successful growth.

Hermann was a man of tremendous ability, energy and enthusiasm. He was very much in love with the two professions in which he participated: the teaching profession and the accounting profession. As a teacher he was widely recognized, and as you know, in 1946 became the chairman of the Department of Accounting in this University. He was recognized by his friends and loved by his students, and a great inspiration to all the men who sat under him.

I suppose there is no one in the state of Ohio who has been so influential in turning students toward the accounting profession as Hermann Miller has been, and I imagine there are lots of CPAs who have fond recollections of the lectures and sessions in which Hermann presided.

As a teacher he was also recognized, because he was made the President of the American Accounting Association, that great national organization, and also the head of the Grand Council of Beta Alpha Psi. He really contributed profoundly to the teaching profession.

As an accountant he was also well recognized. During the war, he held several important positions in the government service. His confreres in the accounting profession recognized his ability and his leadership by electing him the only accounting teacher who has ever headed the Ohio Society of Certified Public Accountants.

So Hermann has contributed tremendously to both the teaching and accounting professions. He was a wonderful man, and I miss him very much.

One of Hermann's strong efforts was in the field of improving the educational qualifications of certified public accountants. In that field, he, in many of the sessions that were held regarding the matter of legislation, was always harping on the fact that the CPA of the future must be a college graduate. I used to think that Hermann was about 25 years ahead of his time. He was not, because as you know, just as late as yesterday a new law has been passed in the Ohio House of Representatives, incorporating, as part of that law, the requirement that the CPA of the future shall be a college graduate. We hope it will go through the Senate and into the hands of the Governor and receive final approval.

It is only natural, then, that when Hermann passed on in 1955 his former students and friends and former associates would want to do something in his memory. So this Hermann Miller Scholarship Fund was created for the purpose of advancing the cause of the teaching of accounting.

A graduate of Ohio State University who is selected by the faculty each year, receives the income from this fund to carry on his further education for this purpose.

This year, Harry Lyle has been selected as the recipient of that award. Unfortunately, he is not able to be here to receive the award, but his faculty adviser, Paul Fertig, knows a great deal about Harry and his qualifications for this award, and I am going to introduce him at this time for that purpose.

MR. PAUL FERTIG: We regret, of course, the fact that Harry could not be here today to receive this award in his own behalf. On the other hand, this gives me an opportunity to say a few words about Harry which he never could have said himself.

Harry is a home-grown product, a native of Hillsboro, Ohio. He holds his Bachelor's and Master's degrees from The Ohio State University. Harry has been an instructor on our staff for several years, and at the present time is beyond his general examinations and is beginning work on his Ph.D. dissertation. He is an experienced accountant, and is active in professional organizations. Most of you know him personally. I think without question that Harry is a real comer. He is dedicated to the teaching profession, and extremely worthy as the recipient of the Hermann C. Miller Scholarship Award. In Harry's behalf, I thank you. (Applause)

BUSINESS CONDITIONS AND MONETARY POLICY

John J. Balles
Vice President, Federal Reserve Bank of Cleveland

I was delighted when Jim McCoy invited me to address the Institute, because not only is it a privilege for me to be with you today, but it is always a personal pleasure to return to Columbus and the campus of The Ohio State University, where I spent a number of very pleasant and rewarding years.

I would like to touch lightly, during the next half-hour, on three areas: the business and credit outlook, the outlook for price stability, and finally, current monetary policy. Obviously, in this short span of time, I cannot present much more than conclusions, without much in the way of supporting evidence.

Turning first to the current pace of business activity, it is interesting to look back into late 1958 and recall that the most common forecast of 1959 business activity at that time was for a rather slow, steady progress in the year but no "boom." It is quite clear now that the pace of economic activity has already exceeded that forecast.

To some extent, this greater-than-expected gain has been influenced by a "hot-house" activity in certain fields, based on anticipation of a steel strike, but over-all economic activity is advancing on a broad front. Last month industrial production reached an all-time high, and more than recovered the recession losses. I think it is particularly worthy of noting that durable-goods manufacturing, one of the major areas hit hard by the recession, has fully recovered. For that matter, the production of non-durable goods has been reaching new highs for some time. In April the output of building material and steel ingots was at an all-time peak. The output of business equipment such as industrial machinery continues to expand. The production of consumer durable goods has continued to grow, for example, furniture, television, and automobiles. The output of textile and chemical products is rising.

Across a very broad front, we are witnessing a strong economic recovery and moving into high ground. Retail sales are up 9 per cent from a year ago. Consumers are spending more freely; this has been reflected in the peak rate of housing starts. Again recalling the prognostications of late 1958, it was thought we would do well to reach 1.2 million new housing starts in 1959. But already this year we have been producing houses at an annual rate of about 1.36 million. That rate, I might add, exceeds the previous peak pace of housing starts in this country, reached in the same period of 1955.

The total construction picture is just as bullish. At this time the total dollar volume is at the annual rate of $54 billion, up sharply from the record of last year of $49 billion.

Personal income is reaching new high ground, up $23 billion from the level of a year ago, and this increase has been mainly in the area of wage and salary payments.

Continuing to run quickly over some of the leading indicators, the next sector is particularly important, because it largely accounts for the ups and downs of the economy. Let us take a look at capital outlays by business. Late last fall the McGraw-Hill Company made a preliminary survey of 1959 spending plans for new plant and equipment, concluding that it would show only a slight gain from the sharply reduced level of 1958. A few months later the Commerce Department and the Securities Exchange Commission, on taking another reading, found that the volume of plant and equipment would rise 4 per cent in 1959. With a still later recheck taken by McGraw-Hill, we come up with a 7 per cent gain. You can see the way things are going; business capital spending plans have already been revised upward several times. A good part of this gain is not necessarily for the addition of new capacity, but for modernization and improvement of existing facilities, particularly to get lower-cost output.

Fortunately, the one sticky area in the recovery movement from the recession of last year—the unemployment picture—quite recently has shown strong improvement. In April, unemployment was down three-quarters of a million, to a level of 3.6 million. The improvement was about double what you would normally expect in April, and it stems from particular strength in the construction industry and hard-goods manufacturing, as well as farming. The unemployment rate is now down to 5.3 per cent of the labor force, in contrast to the 7.5 per cent rate in the depths of the recession. Thus, we have moved about two-thirds of the way back toward the point we were at before the recession, which is 4 or 4½ per cent of the labor force unemployed.

In Ohio the only "major" labor market area still on the "substantial labor surplus list" (having 6 per cent or more of the workers out of jobs) is Toledo. As of May, Youngstown and Lorain came off the list. Columbus is on the "moderate surplus list." In short, I expect a continued reduction in unemployment, as well as a continued pick-up in the number of people employed, now at 65 million.

In summarizing recent and prospective developments, it may be helpful to refer to the gross national product—the dollar value of all final goods and services produced. In the first quarter, the GNP was at the annual rate of $467 billion, up 3 per cent from the fourth quarter, 9 per cent higher than the recession low point (the first quarter of 1958), and 5 per cent higher than the pre-recession peak (the third quarter of 1957). There is no doubt that, even allowing for price increases since 1957, the total output of goods and services has now reached new high grounds.

In this current quarter the gross national product is likely to jump to a rate of $475 billion. Even if there is no steel strike, there may be a period of working down excessive steel inventories in the third quarter, and a consequent levelling tendency in total output. But by the time the fourth quarter rolls around, the GNP may be up to a 485 billion-dollar rate. For the year as a whole, total output may be up 10 per cent from 1958, a pretty sizable gain.

With the generally rosy picture that I have just painted, the question no longer is whether we are going to have an incomplete, rather weak recovery, but whether we are now teetering on the edge of another boom.

With that point in mind, I have made a few guesses as to what major credit demands will be in six major areas for 1959, compared with last year. You may be interested in the results.

Looking at the home-mortgage credit, which typically absorbs the largest single share of funds in the capital market, I think there is a good prospect of a 10 per cent gain in the volume of financing in this area in 1959. Many advance commitments have been made by institutional lenders, and consequently the housing boom and the house-financing boom have a real "head of steam" behind them.

Looking next at the probable volume of external financing by corporations, we find a different story. It will probably fall about 7 per cent this year, which appears strange in view of current inventory accumulations, as well as rising outlays on "brick and mortar." Internal sources of financing, however, are on the rise—retained earnings and depreciation charges.

Municipal financing reached a new peak last year and was largely responsible for the gain in total construction, which in turn was one of the factors that made the recession relatively mild. The net increase in State and local debt last year amounted to $6.3 billion, and I think it will be equalled in 1959. The backlog of bond issues that has been approved by voters but not yet issued is still large. For example, about half of all the bonds approved by voters in the last two years have yet to come to market. This tends to insure a heavy volume for demand for funds. On the other hand, however, the rising level of interest rates may deter some of the municipal bond issues.

Last year, for only the second time in the post-war period, there was a net decline in consumer installment credit, associated principally with the poor automobile year and the recession in general. In the first quarter of this year, however, the increase of installment credit of a billion dollars was the biggest quarterly rise since 1955, a year of record growth in such credit. I do not expect that kind of a surge this year, but it is likely that the total volume of installment credit will go up by at least $3 billion in 1959. Here is another major addition to total demands for funds.

Business borrowing from banks will show the same kind of picture. Last year there was a decline, mainly because business borrowing from banks is closely associated with inventory movements. In 1958, there was a strong liquidation of inventories, while this year they are on the rise. Thus, business loans are likely to rise by at least $2.5 billion in 1959. That is not as much as in 1955 and 1956, but it is a sizeable demand for funds.

Finally, the net addition to the U. S. government debt in 1959 will be bigger than it was in 1958. The effects of the cash budget deficit on the current fiscal year will be felt, in other words, in a rising demand for borrowed funds by the Treasury. Last year the United States government added $8.2 billion to its debt. The increase this year will be about $9.3 billion. It is unfortunate that the government finds it necessary to borrow heavily during a period of strong business activity and heavy private demand for credit. How much different would be the outlook for stable growth and a stable dollar if the Federal government now had something of a budget surplus.

Adding up all of the above guesses, it seems to me that total demands for credit are probably going to be a fifth greater than they were in 1958.

What about the supply side of the market? Basically, loanable funds can come from savings out of current income, particularly as those savings are channeled through investment and savings institutes, plus net expansion in bank credit. Last year total savings rose sharply, which is not unusual for a recession year. But I think a further rise in savings this year cannot be expected. That is to say, I think we will be doing well to maintain the flow of savings into savings and investment institutions at last year's level.

As a rough estimate, I expect a gain of one-fifth in the major credit demands and anticipate that savings going into financial institutions will hold equal to last year. Therefore, it seems to me that there will be strong pressure of demand for bank loans to fill the gap.

The main question of monetary policy hinges on the above prospect. Should this loan expansion in the banking system be financed through the creation of new money? Should the central bank provide enough cash reserves to allow banks to finance loan demand through expanded bank deposits, which is the main part of our money supply? Or should the central bank restrain the growth of the banking system's cash reserves and thus force banks to meet loan demand by selling off the government securities, so the money supply does not rise?

A good part of this $64,000-question hinges on the price outlook. Let us say a few words about that. Over the last year there has been virtually no net movement of the consumer's price index. It is ironic that we should get a coincidence of price stability along with the strongest type of inflationary psychology that we have witnessed in many years.

Of course, there are all kinds of explanations, but I will not have time to go into them in detail. One fact we want to keep in mind is that the consumer price index is sluggish and is the last index to indicate a rise of price pressures. Nevertheless, the fact remains that we have recently had one of the longest periods of price stability in the post-war period, following an earlier period of two and a half years during which the consumer price index marched up at the annual rate of 3.5 per cent.

Even when you look at the wholesale price index, which is more sensitive, you find stability for almost a year. There are at least four factors that account for this stability in the over-all price indices. I would like to mention them and see how much more mileage we can get out of them.

In the first place, one of the reasons the consumer price index (as well as the wholesale index) held steady for a year is that both food and farm prices have been declining. In the consumer price index the drop in food prices has offset a rise in other components of the index. The same way in the wholesale price index. The fall in prices received by farmers has been about enough to offset the rising trend in industrial prices. In short, there is more to "price stability" than meets the eye. It depends on which price you talk about as to whether we have had stability.

A more significant factor accounting for over-all price stability in the past year has been the very sharp increase in productivity which took place during the recession and the immediate period thereafter, that is, a rise in output per man-hour.

A third factor tending to bring a halt to the rise in prices has been the overhang of excess productive capacity.

A fourth factor was a sharply increased degree of competition, both within the economy domestically and competition between our firms and foreign firms.

What is the outlook? Can we continue to count on the above-mentioned factors to hold the price indices on an even keel? Without going into detail, food prices will probably continue to decline, thus tending to offset other forces tending to put consumer prices up. Highly competitive situations in the economy, as well as foreign competition, will also continue to be a restraining force. For example, there was consternation in Cleveland when 300 tons of steel were delivered from Germany. It was like bringing coals to Newcastle. It is sobering to witness a situation in which the United States has become a net importer of steel in the past few months.

As far as further increases in productivity are concerned, during the two previous recovery movements from recessions, productivity increased four or five quarters and then turned down for about six months before showing a further rise. If the same pattern is followed now, we can expect further increases in efficiency in the manufacturing area to last only until mid-year, and possibly show a decline in the second half of 1959.

Finally, the fourth factor that has tended to inhibit further creeping inflation in the last year: the overhang of excess production capacity, has about run out of steam. This can be illustrated by data on 17 major materials—output versus capacity. It is clear that in 1956, when the 17 major materials were being turned out at 94 per cent of capacity, very strong price pressures developed. In 1958, when output of the 17 major materials fell to 66 per cent of capacity, there was terrific price competition. It led the cement industry, for example, to guarantee prices for all of 1959. In the electrical-generator business, some prices were slashed 50 per cent. At this time the 17 major materials are being turned out, on the average, at a rate of 85 per cent of capacity. In short, it appears that we are close to a point where cost pressures will again start to build up, tending toward higher prices.

A great deal depends on the steel wage dispute now in progress. As we look at industrial prices, we find that they have already risen 2.5 per cent since last summer. A steel price increase of any substantial amount could now easily trigger a general cumulative rise of wholesale prices, which eventually will find its way to consumer price index, and we will be back in the track of creeping inflation.

That leads me to conclude with an observation on the type of public policy most appropriate to the current economic scene. The Federal Reserve System is trying to achieve a climate, in so far as it can be done through monetary measures, in which there is orderly and sustainable economic growth and rising standards of living, while avoiding the excesses and inequities that stem from creeping inflation. We do not believe that inflation is inevitable, let alone desirable. In the long run, we are convinced that consumer and business spending decisions based on inflationary expectations are likely to lead to a "boom and bust" economy.

Therefore, the System is using its powers in an attempt to avoid inflation, with a view to promoting a stable rate of economic growth. Key developments on the horizon with respect to price and wage policies of business and labor will determine whether increased credit restraint will be necessary in order to achieve those goals.

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Peters, W. Wm., Jr., Ohio State University, Columbus
Peters, Walter W., Ernst & Ernst, Cincinnati

Porter, Alton L., Dean & Barry Co., Columbus
Porter, Caryl J., Arthur Andersen & Co., Cleveland
Powell, George, Charles E. Merrill Books, Inc., Columbus
Proffitt, Hazel, Atkinson-Dauksch & Talmadge, Columbus
Pulsinelli, Frank P., Keller, Kirschner, Martin & Clinger, Columbus
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Ranbarger, John W., Peoples Broadcasting Corp., Columbus
Rasmussen, Neal A., South-Western Publishing Co., Cincinnati
Rechel, C. F., Columbus Coated Fabrics Corp., Columbus
Rehula, Lad A., Haskins & Sells, Cleveland
Reichardt, Ernst L., Welsh & Leffingwell, Cleveland
Reimer, Don A., Jennings, Lindsey & Reimer, Hamilton
Rhodebeck, Lorene, Farm Bureau Coop. Assoc., Inc., Columbus
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